Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms

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Securities markets have long employed “gatekeepers” - - independent professions who pledge their reputational capital - - to protect dispersed investors. This strategy of relying on reputational intermediaries to assess, verify and certify the corporate issuer’s disclosures appears to have failed during the late 1990s, as accounting irregularities increased exponentially. Part I of this paper assesses the reasons for this failure, emphasizing both a shortfall in deterrence and the sudden shift from a cash-based to an equity-based system of executive compensation during the 1990s. Part II and III then survey the realistic regulatory options and the incomplete steps taken by the Sarbanes-Oxley Act. Breaking down these options into four categories - - structural rules, prophylactic rules, procedural rules, and liability-enhancing rules - -, Part III concludes that simply increasing the threat of liability could cause the market for gatekeeping services to fail. Instead, it proposes a shift towards stricter liability standards coupled with a ceiling on gatekeeper liability set at a level adequate to deter misconduct, but not to compensate investors. Finally, Part III proposes that the role of a new gatekeeper needs to be recognized and formalized: namely, the attorney who prepares a disclosure document, who should, it argues, be forced to provide a functionally parallel certification with regard to this issuer's non-financial disclosures to the certification provided by the auditor with respect to financial disclosures. The feasibility and scope of such a certification requirement, along with its impact on the attorney's other obligations to its client, are explored in Part III.

Securities markets have long employed “gatekeepers” - - independent professionals who pledge their reputational capital - - to protect the interests of dispersed investors who cannot easily take collective action.¹ The clearest
examples of such reputational intermediaries are auditors and securities analysts, who in different ways verify or assess corporate disclosures in order to advise investors. But during the late 1990s, these protections seemingly failed, and a unique concentration of financial scandals followed, all involving the common denominator of accounting irregularities. What caused this sudden outburst of scandals, involving a seeming epidemic of accounting and related financial irregularities, that broke over the financial markets between late 2001 and mid-2002 - e.g., Enron, WorldCom, Global Crossing, Tyco and others? To date, much commentary has broadly and loosely attributed these scandals to any or all of: (1) a stock market bubble; (2) a decline in business morality; (3) weak boards of directors; or (4) an increase in “infectious greed.” Without denying that any

Jr., Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation, 52 Bus. Law. 1195, 1210-13, 1232-33 (1999). For a fuller discussion of the concept of gatekeepers as “reputational intermediaries,” see text and notes infra at notes 9 to 11. The use of such private agents substantially predates the appearance of public regulation, either the federal securities laws or the state “Blue Sky” laws. The New York Stock Exchange began to require the publication of financial statements certified by an independent auditor around 1900, well before the passage of the first “Blue Sky” statute. See John C. Coffee, Jr., The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control, 111 Yale L.J. 1, 37-39 (2001). For a representative such statement, see Stuart L. Gillan and John D. Martin, “Financial Engineering, Corporate Governance and the Collapse of Enron” (SSRN Working Paper id=350040) (2002) at 3 (finding first cause of Enron’s breakdown to have been “a lack of board independence and board oversight”). In contrast, this paper doubts the adequacy of such an explanation. Admittedly, boards did fail, and even a special committee of Enron’s own board has concluded that the Enron board failed to monitor officers for conflicts of interest adequately. See William C. Powers, Jr. et al., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (Feb. 1, 2002), 2002 WL 198018. Similarly, a Senate Subcommittee has assigned the principal blame to the Enron Board. See
of these factors could have played some role, this article begins from the premise that explanations phrased in terms of greed and morality are unsatisfactory because they depend on subjective trends that cannot be reliably measured.

Even explanations that involve critiques of corporate governance involve a related problem in that they fail to account for the sudden increase in financial irregularity. While some boards certainly failed, the overall independence and power of outside directors has only increased over recent years, and the 2001-2002 epidemic of financial irregularity cannot be satisfactorily explained in terms of any recent decline in board performance. To explain an epidemic of irregularity, one must identify some force or factor that changed - - either intensifying or weakening - - so that its influence can account for the overall shift in behavior, and clearly the board’s performance, even if inadequate, did not decline materially over the relevant interval of the 1990s.

A final oversimple explanation is that a “few bad apples” - - i.e., a small group of “rogue managers” who were corrupt - - caused these scandals. This explanation overlooks

the pervasiveness of the sudden surge in financial irregularities in the late 1990s. As will be seen, approximately 10% of all publicly listed U.S. companies restated their financial statements at least once between 1997 and June 2002, and the annual rate of financial restatements soared during the latter half of the 1990s. Such financial irregularity is, of course, characteristic of a bubble, and little doubt now exists that a large frothy bubble burst in 2000-2001. As a historical matter, bubbles tend to produce scandals and, in turn, prophylactic legislation, but this loose generalization leaves unanswered the critical questions: what caused this bubble and how does the growth of a bubble relate to the apparent breakdown of our once-confident system of corporate governance?

This article will focus on an alternative explanation for the wave of accounting and financial reporting irregularities that surfaced in 2001-2002: namely, that the gatekeepers failed. That is, the professionals who serve investors by preparing, verifying, or certifying corporate disclosures to the securities markets acquiesced in managerial fraud - - not in all cases, to be sure, but at a markedly higher rate than during the immediately preceding period. While the


5 See text and notes infra at notes 18 to 24.

6 Professor Stuart Banner has argued that, over the last 300 years, most major instances of legislation regulating the securities markets have followed a sustained price collapse on the securities market. See Stuart Banner, What Causes New Securities Regulation?: 300 Years of Evidence, 75 Wash. U. L.Q. 849, 850 (1997).
concept of gatekeeper will be discussed and refined later, this term certainly includes the auditors, securities analysts, and securities attorneys who prepare, review, or analyze disclosure documents. Part I of this article develops competing, but complimentary, explanations for gatekeeper failure. The behavior of gatekeepers cannot be examined in isolation, but rather appears to have been significantly influenced by the incentives that drove corporate managers over the same period. To this extent, the recent explosion of financial irregularity was less the product of ineffable factors - such as “infectious greed” or mass irrationality - than the natural and logical consequence of trends and forces that had been developing for some time. Ironically, the blunt truth is that both the recent accounting scandals and the broader phenomenon of earnings management were the by-products of a system of corporate governance that has indeed made corporate managers more accountable to the market. Sensitivity to the market, however, can be a mixed blessing - particularly when the market becomes euphoric and uncritical. As a result, a corporate governance system that was adequate for a world in which the agents’ incentives to act opportunistically were weaker failed when these same agents - managers, gatekeepers and financial intermediaries - responded to stronger incentives and rationally pursued their own self-interests to the detriment of shareholders.

Part I will conclude that the factor that most destabilized our contemporary corporate governance system was the sudden change in executive compensation during the 1990s. As executive compensation shifted to being
equity-based, instead of cash-based, a greatly enhanced incentive arose for
managers to manipulate earnings - - and to induce their gatekeepers to let them.
To this extent, blaming the board is a myopic theory of causation that leads
nowhere, because it does not explain the sudden surge in irregularities. In truth,
in most cases, boards cannot detect earnings manipulation in the absence of
warnings from their professional gatekeepers.

While Part I offers a diagnosis, it proposes no prescription. Part II
approaches this task by first mapping the range of strategies available to
regulators. Basically, it groups the realistic regulatory options for dealing with
conflicts of interest under four headings: (1) structural rules; (2) prophylactic
rules; (3) procedural rules, and (4) liability-enhancing rules. Seeking to curb the
conflicts of interest that compromised auditors and analysts, the Sarbanes-Oxley
Act of 2002, passed by Congress in response to the wave of corporate scandals
that crested in 2002, utilizes all these strategies - - except the last. Although
enhancing liability rules is probably the most obvious and traditional response to
scandals, this was also the one strategy that business interests effectively resisted
during the enactment of Sarbanes-Oxley. Ironically, however, even though
Congress has not used this technique, courts today appear to have enhanced the
risk of legal liability on their own through the creative reinterpretation of
ambiguous doctrines.

7 Technically, this statute is entitled the “Public Company Accounting Reform and
But therein lies a host of problems. Although gatekeepers need to face some legal threat to keep them faithful to shareholders, the optimal level of deterrence is much harder to estimate. An “excessive” threat may both impair the financial viability of gatekeepers, even closing down the market for gatekeeping services, and impede the ability of many corporations to recruit qualified, outside directors. Part II therefore assesses the magnitude of the litigation “threat” that is now developing as a prelude to suggesting other reforms that may be desirable because they seek to modify gatekeeper behavior by means that do not threaten the solvency of gatekeepers.

Finally, Part III proposes alternative reforms intended to make gatekeepers more responsive to the interests of investors. Initially, Part III evaluates a possible model under which auditors should face heightened liability, but with their maximum exposure capped at a multiple of their expected revenue from the client that would be sufficient to achieve adequate deterrence. The attraction of this combination is that it combines the better incentives of strict liability with a system that both places a realistic ceiling on the gatekeeper’s aggregate liability and minimizes the transaction costs associated with enforcement. Concededly, this proposal subordinates the goal of compensation to that of deterrence, but gatekeepers are simply not of the economic scale to be able to fund significant compensation to investors, particularly in the new era of mega-litigation. This proposed approach also reduces reliance that must be placed on courts for costly and unpredictable liability determinations. Most importantly, by moving towards
a strict liability system, this proposal eliminates the incentive for auditors to rationalize or overlook fraud or irregularity and later assert that they were deceived by management. Thus, it enhances auditor performance without risking collapse of the market for auditing services.

Part III recognizes, however, that all gatekeepers are not alike, that critical distinctions exist between auditors and attorneys in terms of their typical functional activity, and that a model appropriate for one gatekeeper need not be appropriate for all. In that light, Part III does not propose strict liability for attorneys, but instead a structural reform: namely, imposing gatekeeper responsibilities on attorneys to monitor their corporation’s disclosures, with a special emphasis on non-financial disclosures. In principle, the attorney should be given a functionally similar responsibility for non-financial disclosures as the auditor now has for financial disclosures. Easy as this is to say, the devil lies in the details. Specifically, Part III responds by outlining a certification requirement, an enhanced independence standard for special contexts, and a due diligence obligation under which the SEC could suspend or disbar securities attorneys who failed negligence or malpractice tests. To be sure, the SEC has already begun to move modestly and tentatively in this same direction by adopting an “up-the-ladder” internal reporting requirement under which attorneys must report evidence of a material violation of law that they acquire in their representation of the corporation to the corporation’s general counsel or, if
necessary, its audit committee. While important, this requirement deals only with a special context (violations of law) and does not create, as the proposed reforms would, a generalized obligation for at least a certifying attorney to monitor the accuracy of the corporation’s non-financial disclosures.

Of course, any claim that the attorney is, or should be, a gatekeeper, will trigger predictable responses from the bar that such a role conflicts with the other roles that attorneys perform or that it will dry up the flow of information between attorneys and clients. Part III assesses and rejects these arguments, concluding that the principal consequence of expressly recognizing attorneys as gatekeepers will be instead to enhance their leverage with their clients. In short, the unrecognized consequence of expanded ethical or professional obligations is to empower the gatekeeper, thus responding appropriately to the phenomenon of “gatekeeper failure.”

Part I: Gatekeepers: Past and Present

A. Defining the Concept. The term “gatekeeper” has been widely used to refer to the outside professionals who serve the board or investors. Two core ideas underlie the concept of gatekeeper, and it is important to distinguish

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8 See Securities Act Release No. 33-8185 (“Implementation of Standards of Professional Conduct for Attorneys”) (February 6, 2003); see also text and notes infra at notes 126 to 130.
between them: First, the gatekeeper is a person who has significant reputational capital, acquired over many years and many clients, which it pledges to assure the accuracy, or at least the honesty, of statements or representations that it either makes or verifies. Second, the gatekeeper receives a far smaller benefit or payoff for its role, as an agent, in approving, certifying, or verifying information than does the principal from the transaction that the gatekeeper facilitates or enables. Thus, because of this lesser benefit, a lesser expected penalty should be sufficient to deter. This latter premise applies even if the gatekeeper has no reputational capital. Yet, from both perspectives, the presence of gatekeepers increases the prospects for deterrence and law compliance.

The term “gatekeeper” has also been used more broadly to refer to any person or entity who provides a necessary service or certification without which the corporation cannot accomplish a transaction.10 This may accurately describe their organizational position, but it seems overly broad because it ignores both the deterrent capacity of the gatekeeper and whether it possesses reputational capital. Under this broader definition, Microsoft might become a “gatekeeper” for most of the business world (on the assumption that its basic Windows technology was

10 Professor Reinier Kraakman has defined “gatekeepers” as private parties who are able to prevent misconduct by withholding their cooperation from wrongdoers. See Reinier Kraakman, Gatekeepers: The Anatomy of a Third Party Enforcement Strategy, 2 J.L. Econ. & Org. 53 (1986); see also Kraakman, Corporate Liability Strategies and the Costs of Legal Controls, 93 Yale L.J. 857 (1984). This definition strikes me as much too broad, at least for purposes of discussing the role of professionals. It would potentially hold liable persons who sold pencils to Al Capone’s gang on the grounds that one could not run a brewery and tavern business without using pencils to keep records.
indispensable). Thus, this article will use the term “gatekeeper” more narrowly to mean a reputational intermediary who provides verification or certification services to investors. Still, the focus on the gatekeeper’s role in providing a necessary service or certification is useful, because it suggests a regulatory strategy on which this article will focus: by mandating gatekeepers, the law can maximize the probability of deterrence by creating a necessary actor whose compliance with the law it can more effectively influence.

Obvious examples of gatekeepers who provide such verification or certification services would include: (1) the auditor providing its certification of the issuer’s financial statements; (2) the debt rating agency certifying the issuer’s creditworthiness (or relative creditworthiness); (3) the security analyst providing its objective assessment of the corporation’s technology, competitiveness, or earnings prospects; (4) the investment banker providing its “fairness opinion” as to the pricing of a merger; and (5) the securities attorney for the issuer providing its opinion to the underwriters that all material information of which it is aware concerning the issuer has been properly disclosed. The underwriter in an initial public offering is probably also a gatekeeper in the sense that its reputation is implicitly pledged and it is expected to perform due diligence services. Some professions (most notably, the auditor) provide services that consist primarily of gatekeeping, whereas other professions engage in such services only as an ancillary activity (for example, as discussed later, the attorney is primarily an advocate or a transaction engineer and only sometimes a gatekeeper).
Characteristically, the professional gatekeeper essentially assesses or vouches for the corporate client's own statements about itself or a specific transaction. This duplication is desired because the market recognizes that the gatekeeper has a lesser incentive to deceive than does its client and thus regards the gatekeeper's assurance or evaluation as more credible. Unavoidably, the gatekeeper as a watchdog is compromised to a degree by the fact that it is typically paid by the party that it is to monitor. Still, the gatekeeper’s relative credibility stems from the fact that it in effect pledges a reputational capital that it has built up over many years of performing similar services for numerous clients.

In theory, the gatekeeper as an entity would not rationally sacrifice its reputational capital for a single client or a modest fee.

Nonetheless, here as elsewhere, logic and experience can conflict. Despite the clear logic of the gatekeeper rationale, reliance on gatekeepers can prove to have been misplaced for any of the following reasons:

(1) There could be a sudden decline in the deterrent threat facing gatekeepers, thereby increasing their willingness to take legal risks;

(2) The inducements offered to gatekeepers to breach their duties could similarly be increased, with the same likely result;

(3) The value of reputational capital could decline, possibly because investors came to place less weight on gatekeeping services in a “bubble market;”

(4) The prospective injury to a gatekeeper’s reputational capital from involvement in a scandal could also decline, possibly because, in a very
concentrated market (such as the market for auditing services), it becomes foreseeable that all the principal firms in the market will be involved in some scandals and hence investors cannot distinguish meaningfully among them (i.e., the information costs become too high for ordinary investors); or

(5) Principal/agent problems can arise within gatekeeper firms with the result that agents can rationally decide to risk the firm’s reputational capital to a degree that the firm as a whole would not. This decision to risk reputational capital that primarily belongs to others may be rational for the agent, but not for the firm.

For all these reasons, professional gatekeepers may sometimes acquiesce in managerial fraud, even though the apparent reputational losses seem to dwarf the gains to be made from the individual client.11

Much evidence corroborates each of the foregoing hypotheses and suggests that the “few bad apples” theory is simply incorrect as applied to the performance of gatekeepers in the late 1990s. Still, if we shift from theory to the world of real actors, the facts surrounding Arthur Andersen’s fall in 2002. In theory, Andersen should not have acquiesced in accounting irregularities, because it had many clients, each of whom pay a fee that was modest in proportion to the firm's overall revenues. Specifically, Arthur Andersen had approximately 2,300

11 This observation is hardly original with this author. See, for example, Robert A. Prentice, The Case of the Irrational Auditor: A Behavioral Insight Into Securities Fraud Litigation, 95 Nw. U. L. Rev. 1333 (2000).
audit clients. On this basis, the firm seemingly had little incentive to risk its considerable reputational capital for any one client, even if that client paid a multi-million dollar fee. As will be seen however, each of the foregoing hypothesis can contribute to an explanation of gatekeeper failure.

Nonetheless, during the 1990s, many courts bought the logic that gatekeepers do not fail hook, line and sinker. For example, in DiLeo v. Ernst & Young, Judge Easterbrook, writing for the Seventh Circuit, outlined precisely the foregoing theory:

“The complaint does not allege that [the auditor] had anything to gain from any fraud by [its client]. An accountant’s greatest asset is its reputation for honesty, closely followed by its reputation for careful work. Fees for two years' audits could not approach the losses [that the auditor] would suffer from a perception that it would muffle a client's fraud .... [The auditor's] partners shared none of the gain from any fraud and were exposed to a large fraction of the loss. It would have been irrational for any of them to have joined cause with [the client].”

Of course, the modest fees in some of these cases (for example, the audit fee was only $90,000 in Robin v. Arthur Young & Co.) were well less than the $100 million in prospective annual fees from Enron that Arthur Andersen & Co. explicitly foresaw. But this difference in magnitude cannot really explain Arthur

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13 901 F.2d 624 (7th Cir. 1990); see also Melder v. Morris, 27 F.3d 1097, 1103 (5th Cir. 1994); Robin v. Arthur Young & Co., 915 F.2d 1120, 1127 (7th Cir. 1990) (mere $90,000 annual audit fee would have been an irrational motive for fraud).
14 See Dileo v. Ernst & Young, 901 F.2d at 629.
Andersen's collapse. Even if Arthur Andersen saw Enron as a potential $100 million client, it must be remembered that Arthur Andersen generated over $9 billion in revenues in 2001 alone (so that its expected Enron revenues would total only around 1% of its aggregate revenues).\textsuperscript{16} Hence, a fuller explanation seems necessary.

\textbf{B. The Auditing Profession During the 1990s: A Study in Transition}

Once among the most respected of all professionals service firms (including law, accounting, and consulting firms), Andersen became involved in a series of now well-known securities frauds - - e.g., Waste Management, Sunbeam, HBOCMcKesson, The Baptist Foundation, and Global Crossing - - that culminated in its disastrous association with Enron. Those who wish to view the recent corporate scandals as simply the work of a “few bad apples” may seek to characterize Arthur Andersen as a deviant firm, in effect an “outlaw” that masqueraded as an honest sheriff. This theory, however, simply does not hold water. The available evidence in fact suggests that, in terms of the percentage of accounting restatements experienced by its audit clients, Andersen was not significantly different from its peers and experienced the same (or lesser) rate of financial restatements.\textsuperscript{17} To the extent it was different, the leading difference may

\textsuperscript{16} Arthur Andersen's website reports that revenues for 2001 were $9.34 billion. See \url{www.andersen.com}. Also, the $100 million figure was the expected revenue per year that Andersen partners foresaw in the future, when overall revenues would presumably also increase.

\textsuperscript{17} Compared to its peers within the Big Five accounting firms, Arthur Andersen appears to have been responsible for a less than its proportionate share of earnings restatements. While it audited 21% of Big 5 audit clients, it was responsible for only 15% of the restatements experienced by the Big Five firms.
have been only that it was less lucky. All in all, the more logical inference to
draw from the “accounting irregularity” scandals of 2001-2002 is that an erosion
in the quality of financial reporting occurred sometime during the 1990s.

Indeed, this is the area where the data seems the clearest. During the
1990s, earnings restatements, long recognized as a proxy for fraud, suddenly
soared. One study, conducted in 2001 by Moriarty and Livingston, found that the
number of earnings restatements by publicly held corporations averaged 49 per
year from 1990 to 1997, next increased to 91 in 1998, and then skyrocketed to
150 and 156 in 1999 and 2000, respectively.18 A later, fuller study conducted by
the United States General Accounting Office in October, 2002, examined all
financial statement restatements (not just earnings restatements) and also found a
similarly sharp, discontinuous spike in 1999 that has continued through 2002.19
The GAO Study’s data shows the following trend line:20

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18 See Moriarty and Livingston, Quantitative Measures of the Quality of Financial
Reporting, 17 Financial Executive 53, 54 (July/August 2001).
19 See United States General Accounting Office, Report to the Chairman,
Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Financial
Statement Restatements: Trends, Market Impacts, Regulatory Responses and
Remaining Challenges (October 2002) (GAO-03-138) at 4-5 (hereinafter, “GAO
Study”).
20 Id. at 15.
If the GAO Study’s projection of 250 financial statement restatements for 2002...
proves roughly correct, it will mean that the number of restatements increased by approximately 270% over the five years ending in 2002.

Not all restatements, however, are equal. Some may involve small, infrequently traded companies or involve only trivial changes or trigger only modest stock price reactions, while others may be on a scale with Enron or WorldCom. Therefore, it is useful to focus more precisely on financial statement restatements by companies listed on the NYSE, Amex, and Nasdaq, thereby excluding smaller companies that trade only on regional exchanges or over the counter. On this basis, between 1997 and 2001, the proportion of listed companies on the NYSE, Amex and Nasdaq that restated their financial statement approximately tripled, increasing from less than 0.89 percent in 1997 to approximately 2.5 percent in 2001.\textsuperscript{21} Indeed, the GAO Study further predicted that this percentage would reach nearly 3 percent in 2002.\textsuperscript{22} Overall, the GAO Study found that from January 1997 to June 2002, approximately “10 percent of all listed companies announced at least one restatement.”\textsuperscript{23} Also noteworthy was the fact that the size (in terms of market capitalization) of the typical restating company rose rapidly over this period,\textsuperscript{24} and in 2002, companies listed on the NYSE or Nasdaq accounted for over 85 percent of all restatements identified in

\begin{itemize}
\item \textsuperscript{21} Id. at 4.
\item \textsuperscript{22} Id.
\item \textsuperscript{23} Id.
\item \textsuperscript{24} Specifically, the average (median) size by market capitalization of a restating company rose from $500 million ($143 million) in 1997 to $2 billion ($351 million) in 2002. Id.
\end{itemize}
In theory, financial restatements could simply be the product of changes in regulatory rules and this could signify relatively little. But any possibility that issuers are indifferent to restatements can quickly be dispelled. In the real world, issuers resist restatements because they fear the stock price drops, securities class actions, and SEC investigations that generally follow in the wake of financial statement restatements. Indeed, the GAO Study found that stock prices of restating companies over the 1997 to 2001 period suffered an immediate market-adjusted decline of almost 10 percent on average, measured on the basis of the stock’s three day price movement from the trading day before the announcement through the trading day after the announcement. Between 1997 to 2002, restating firms lost over $100 billion in market capitalization just over this three trading day period surrounding a restatement announcement. Given these significant and adverse stock price effects, it is implausible to read the sharp increase in restatements at the end of the 1990s as the product of any new tolerance for, or indifference to, restatements. Even if (as some audit firms have contended) some portion of the change might be attributed to a new SEC pronouncements or, more generally, to a SEC activism about “earnings

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25 Of the 125 actual restatements identified through mid-2002, 54 were listed on Nasdaq, and 53 were listed on the NYSE (for a total of 107 or 85%). 26 The GAO Study also found a longer term market-adjusted decline of 18 percent over the period from 60 trading days before the announcement to 60 trading days after the announcement. 27
management,”28 which became an SEC enforcement priority by 1998,29 this explanation cannot carry us very far. Although SEC activism might trigger some increase in the number of restatements, it cannot explain the growth in the magnitude of restatements or the sharp stock price decline (averaging 10%) on their announcement.30 “Technical” restatements made simply to comply with new SEC interpretations should not produce these stock prices reactions. Clearly, such reactions show that the market was surprised.

The available data shows that, during the late 1990s, the magnitude of financial restatements increased, both in absolute terms (nearly doubling) and as a percentage of the issuer’s rapidly increasing market capitalization.31 This

28 Accounting firms have sometimes attempted to explain this increase in restatements on the basis that the SEC tightened the definition of “materiality” in the late 1990s. This explanation is not very convincing, in part because the principal SEC statement that tightened the definition of materiality - - Staff Accounting Bulletin No. 99 - - was issued in mid-1999, after the number of restatements had already begun to soar in 1998. Also, SAB No. 99 did not truly mandate restatements, but only advised that any rule of thumb employed by auditors and issuers that assumed that amounts under 5% were inherently immaterial could not be applied reflexively. See Staff Accounting Bulletin No. 99, 64 F.R. 45150 (August 19, 1999).

29 The SEC’s prioritization of earnings management as a principal enforcement target can be approximately dated to SEC Chairman Arthur Levitt's now famous speech on the subject in 1998. See Arthur Levitt, “The Numbers Game, Remarks at NYU Center for Law and Business” (Sept. 28, 1998).

30 See text and notes supra at notes 24 to 26.

31 According to Moriarty and Livingston, supra note 18, companies that restated earnings suffered market losses of $17.7 billion in 1998, $24.2 billion in 1999, and $31.2 billion in 2000. Id. at 55. Expressed as a percentage of the overall capitalization of the market (which was ascendingly hyperbolically over this period), these losses for 1998 through 2000 came to 0.13%, 0.14% and 0.19%, respectively, of market capitalization. In short, however expressed, the relative size of the losses increased over this period.
suggests that managers became progressively willing over this period to take greater risks. Moreover, as the decade of the 1990s wore on, earnings restatements were increasingly experienced by large, mature, publicly-held firms, rather than by smaller or newly public companies that might be expected to be more inexperienced or rash. Managerial behavior within the largest firms then seems to have changed over this period.

In particular, the GAO Study’s data corroborates this interpretation that managerial behavior changed, because it shows a significant change in motive. Although there are many reasons why a company may restate its financial statements (e.g., to adjust costs or expenses or to recognize liabilities), one particular reason dominated during the period from 1997 to 2002. The GAO study found that issues involving revenue recognition accounted for almost 39 percent of the 919 announced restatements that it identified over the 1997 to 2002 period. In effect, attempts by management to prematurely recognize income appear to have been the most common cause of restatements. Earlier in the decade and during prior decades, earnings management was more a game of “smoothing out” the peaks and valleys in a corporation’s income flow in order to reduce the apparent volatility in the corporation’s returns. Thus, managements characteristically attempted to hide “excess earnings” in “rainy day reserves” in order to use such funds later to smooth out undesired declines in the firm’s

32 See GAO Study, supra note 3, at 5. Revenue recognition was also the leading reason for restatements in each individual year over this period. Id.
33 While revenue recognition restatements accounted for 39 percent of restatements over the 1997 to 2002 period, they were associated with $56 billion (or roughly 56%) of the $100 billion in market capitalization that restating companies lost over this period. Id. at 28.

Despite this earlier preference for income-smoothing, by the end of the 1990s, these same firms were robbing future periods for earnings that could be recognized immediately. In short, “income smoothing” gave way to more predatory behavior. Interestingly, restatements involving revenue recognition produced disproportionately large losses.33 Seemingly, the market feared revenue-timing restatements more than others because of the apparent signal they carried that reported earnings could not be trusted. Yet, despite the market’s antipathy for them, revenue recognition restatements became the most common form of restatement. At a minimum, this suggests that the interests of management and shareholders were not aligned, and gatekeepers appear to have been progressively caught in the middle.

B. Security Analysts During the 1990s

Before any attempt is made to generalize about the motivations that led managements to pressure their auditors for premature revenue recognition, it is useful to recognize that this pattern of increased acquiescence by the gatekeeper to its clients’ demands during the 1990s was not limited to the auditing profession. Security analysts are probably the only other profession that has experienced equivalent (or harsher) criticism since the collapse of the high-tech bubble in 2000. Again, growing conflicts of interest appear to explain their
change in behavior.

Some of the evidence relating to gatekeeper failure involving analysts is anecdotal, but striking. As late as October 2001, shortly before Enron’s bankruptcy, 16 out of the 17 securities analysts covering Enron maintained “buy” or “strong buy” recommendations on its stock. Yet, months earlier as of December 31, 2000, Enron already had a stock price that was 70 times earnings and six times its book value, and had earned an 89% return for the year (despite a 9% decrease over the same period for the S&P 500 index). Such a profile should have seemingly alerted any analyst who was even half awake to the possibility that Enron was seriously overvalued. Symptomatically, however, the first brokerage firm to downgrade Enron to a “sell” rating in 2001 was Prudential Securities, which did not then engage in investment banking activities. Prudential was also believed to have the highest proportion of sell ratings among the stocks it evaluated. Perhaps, Prudential also woke up late, but it is still at

34 See “Statement of Frank Torres, Legislative Counsel, Consumers Union, Before the United States Senate, Committee on Governmental Affairs, on the Collapse of Enron: The Role Analysts Played and the Conflicts They Face,” February 27, 2002, at p.6 (“In the case of Enron, 16 out of 17 analysts had a buy or a strong buy rating, one had a hold, none had a sell - - even as the company stock had lost over half its value and its CEO suddenly resigned.”). 2002 WL 2011028; see also testimony of Frank Partnoy, Professor of Law, University of San Diego School of Law, Hearings before the United States Senate Committee on Governmental Affairs, January 24, 2002 (similar 16 out of 17 tabulation).
37 Id.
least revealing that the least conflicted were the first to awake.

How close then are the similarities between analysts and auditors? Much like auditors, analysts are also “reputational intermediaries,” whose desire to be perceived as credible and objective may often be subordinated to their desire to retain and please investment banking clients. One statistic inevitably comes up in any assessment of analyst objectivity: namely, the curious fact that the ratio of “buy” recommendations to “sell” recommendations has recently been as high as 100 to 1. In truth, this particular statistic may not be as compelling as it initially sounds because there are obvious reasons why “buy” recommendations will normally outnumber “sell” recommendations, even in the absence of conflicts of interest. Yet, a related statistic may be more revealing because it underscores the apparent transition that took place in the 1990s and parallels the earlier noted increase in accounting restatements during the 1990s. According to a study by

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38 A study by Thomas Financial/First Call has found that less than one percent of the 28,000 stock recommendations issued by brokerage firm analysts during late 1999 and most of 2000 were “sell” recommendations. See Opening Statement of Congressman Paul E. Kanjorski; Ranking Democratic Member, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, “Hearing on Analyzing the Analysts,” June 14, 2001 at p. 1 (citing and discussing study).

39 “Sell-side” analysts are employed by brokerage firms that understandably wish to maximize brokerage transactions. In this light, a “buy” recommendation addresses the entire market and certainly all the firm’s customers, while a “sell” recommendation addresses only those customers who own the stock (probably well less than 1%) and those with margin accounts who are willing to sell the stock “short.” In addition, “sell” recommendations annoy not only the issuer company, but also institutional investors who are afraid that sell recommendations will “spook” retail investors, causing them to panic and sell, while the institution is “locked into” a large position that cannot easily be liquidated.
Thomson Financial, the ratio of “buy” to “sell” recommendations increased from 6 to 1 in 1991 to 100 to 1 by 2000.\textsuperscript{40}

Other evidence corroborates this picture of a systematic analyst bias towards optimism. Studying security analyst career patterns over the last two decades, Hong and Kubik find that career advancement for analysts depended more on a bias towards optimism than on the overall accuracy of their forecasts.\textsuperscript{41} Although accuracy did matter, a tendency to be more optimistic than the consensus of analysts seemed to protect analysts from downward movement within their industry’s hierarchy, and this tendency was most pronounced in the case of analysts who covered stocks underwritten by their own firms.\textsuperscript{42} More importantly, this tendency for optimism to outweigh accuracy increased during the late 1990s.\textsuperscript{43} They interpret their findings as at least consistent with the view “that Wall Street lost any self-discipline to produce accurate research during the recent stock market mania.”\textsuperscript{44} Perhaps, this assessment overstates, but the conclusion seems hard to escape that something happened during the 1990s that compromised the independence and objectivity of the gatekeepers on whom our private system of corporate governance depends.\textsuperscript{45} Even before Enron, much

\begin{footnotesize}
\begin{enumerate}
\item See Opening Statement of Congressman Paul E. Kanjorski, supra note 38, at 1. (citing study by First Call).
\item See Harrison Hong and Jeffrey Kubik, Analyzing the Analysts: Career Concerns and Biased Earnings Forecasts, 58 J. Fin. 313 (2003).
\item Id. at 341.
\item Id. at 342 and 346 (finding that between 1996 and 2000, a strong bias towards optimism decreased an analyst’s risk of downward movement in the industry).
\item Id. at 345-46.
\item Participants in the industry also report that its professional culture changed dramatically in the late 1990s, particularly as investment banking firms began to
\end{enumerate}
\end{footnotesize}
evidence showed that the most sophisticated market participants understood the extent of these conflicts and had ceased to rely on “sell side” analysts.46

C. Explaining Gatekeeper Failure.

The same observation has probably occurred to many: none of the watchdogs that should have detected Enron's collapse - - auditors, analysts or debt rating agencies - - awoke before the penultimate moment. This is the common denominator, not just in the case of Enron, but also in many of the other “accounting irregularity” cases of 2001-2002. What plausible hypothesis can explain the collective failure of these gatekeepers? Here, several different, although ultimately complementary, stories can be told. Initially, this section will first review two generalized stories: the first will be called the “general deterrence” story; and the second, the “bubble” story. Then, it will focus on allocating responsibility among gatekeepers, managers, and investors.

1. The Deterrence Explanation: The Underdeterred Gatekeeper

The general deterrence story focuses on the decline in the expected liability costs associated with acquiescence by auditors in aggressive accounting policies favored by managements. It postulates that, during the 1990s, the risk of

46 Although the empirical evidence is limited, it suggests that “independent” analysts (i.e., analysts not associated with the underwriter for a particular issuer) behave differently than, and tend to outperform, analysts who are associated with the issuer's underwriter. See R. Michaely and K. Womack, Conflict of Interest and the Credibility of Underwriter Analyst Recommendations, 12 Review of Financial Studies 653 (1999).
auditor liability declined, while the benefits of acquiescence increased.

Economics 101 teaches us that when the costs go down, while the benefits associated with any activity go up, the output of the activity will increase. Here, the activity that increased was auditor acquiescence.

Prior to the 1990s, auditors faced a very real risk of civil liability, principally from class action litigation. Why did the legal risks go down during the 1990s? The obvious list of reasons would include:

(a) the Supreme Court’s Lampf, Pleva decision, which in 1991 significantly shortened the statute of limitations applicable to securities fraud.

As of 1992, Congress was advised that the securities fraud litigation costs for just the six largest accounting firms (then the “Big Six”) accounted for $783 million, or more than 14% of their audit revenues. Potential exposure to loss was in the billions. See Private Litigation Under the Federal Securities Laws: Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 103rd Cong., 1st Sess. No.103-431 (1993) (statement of Jake L. Netterville), reprinted in Fed. Sec. L. Rep. (CCH) No. 1696, (January 10, 1996). One major auditing firm, Laventhol & Horwath, did fail and entered bankruptcy as a result of litigation and associated scandals growing out of the savings and loan scandals of the 1980s. See “What Role Should CPA’s be Playing in Audit Reform?,” Partner’s Report for CPA Firm Owners, April, 2002 (discussing experience of Laventhol & Horwath). The accounting profession’s bitter experience with class litigation in the 1980s and 1990s probably explains why it became the strongest and most organized champion of the Private Securities Litigation Reform Act of 1995.

Lampf, Pleva, Lipkind & Petigrow v. Gilbertston, 501 U.S. 350, 359-61 (1991) (creating a federal rule requiring plaintiffs to file within one year of when they should have known of the violation underlying their action, but in no event more than three years after the violation). This one to three year period was typically shorter than the previously applicable limitations periods which were determined by analogy to state statutes and often permitted a five or six year delay - - if that was the period within which a common law fraud action could be maintained in the particular state.
(b) the Supreme Court's Central Bank of Denver decision,\(^{49}\) which in 1994 eliminated private "aiding and abetting" liability in securities fraud cases;

(c) the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which (i) raised the pleading standards for securities class actions to a level well above that applicable to fraud actions generally; (ii) substituted proportionate liability for "joint and several" liability; (iii) restricted the sweep of the RICO statute so that it could no longer convert securities fraud class actions for compensatory damages into actions for treble damages; and (iv) adopted a very protective safe harbor for forward-looking information; and

(d) the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), which abolished state court class actions alleging securities fraud.\(^{50}\)

The individual impact of each of these changes probably cannot be reliably measured, but their concurrent aggregate impact is clear: they greatly reduced the plaintiffs’ incentives in securities class actions to sue secondary participants, such as auditors, analysts, and attorneys. As an SEC study noted, the number of audit-related suits filed against the then “Big Six” accounting firms in 1990 to 1992 was 192, 172, and 141, respectively.\(^{51}\) Yet, in the first year


\(^{51}\) See U.S. Securities and Exchanges Commission, Office of the General Counsel, REPORT TO THE PRESIDENT AND THE CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995. (April, 1997) at 22 (available on SEC website at
following the passage of the PSLRA (1996), the SEC found that out of the 105 securities class actions it found to have been filed in that year, accounting firms were named in only six cases, corporate counsel in no cases, and underwriters in nineteen cases.\textsuperscript{52} It concluded:

\begin{quote}
“Secondary defendants such as accountants and lawyers, are being named less frequently in securities class actions.”\textsuperscript{53}
\end{quote}

Not only did the threat of private enforcement decline, but the prospect of public enforcement similarly subsided. In particular, there is reason to believe that, from some point in the 1980s until the late 1990s, the SEC shifted its enforcement focus away from actions against the Big Five accounting firms towards other priorities.\textsuperscript{54} In any event, the point here is not that any of these

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\item \texttt{http://www.sec.gov/news/studies/lreform.txt}  The figures for the years 1990 to 1992 were reported to the SEC by the Big Six and include all class actions against them, which could include some non-securities class actions. Nonetheless, the number of such non-securities actions seems likely to have been small. As the above SEC study further notes: “[D]uring the period from 1991 through June 1996, accountants were defendants in 52 reported settlements (as opposed to complaints)...and law firms were defendants in 7. Thus, there seems to be a real decline in the number of lawsuits against secondary defendants.” \textit{Id.} at 22.
\item Id. at 21 to 22. \textsuperscript{52}
\item Id. at 4. As this study expressly noted, this decline could have been caused both by the PSLRA and the Supreme Court’s decision in \textit{Central Bank of Denver} in 1994 that ended private “aiding and abetting” liability under Rule 10b-5. See text and note supra at note 49. \textsuperscript{53}
\item This point has been orally made to me by several former SEC officials, including Stanley Sporkin, the long-time former head of the Commission’s Division of Enforcement. They believe that the SEC’s enforcement action against Arthur Andersen, which was resolved in June, 2001, was one of the very few (and perhaps the only) enforcement action brought against a Big Five accounting firm on fraud grounds during the 1990's. See Securities and Exchange Commission v. Arthur Andersen LLP, SEC Litigation Release No. 17039, 2001 SEC LEXIS 1159 (June 19, 2001). Although the Commission did bring charges during the 1990s against individual partners in these firms, the Commission appears to have
\end{itemize}
changes were necessarily unjustified or excessive, but rather that their collective impact was to appreciably reduce the risk of liability. Auditors were the special beneficiaries of many of these provisions. For example, the pleading rules and the new standard of proportionate liability protected them far more than it did most corporate defendants. Although auditors are still sued today, the settlement value of cases against auditors has gone way down.

Correspondingly, the benefits of acquiescence to auditors rose over this same period, as the Big Five learned during the 1990s how to cross-sell consulting services and to treat the auditing function principally as a portal of entry into a lucrative client. Prior to the mid-1990s, the provision of consulting services to audit clients was infrequent and insubstantial in the aggregate. Yet, 

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55 At a minimum, plaintiffs today must plead with particularity facts giving rise to a "strong inference of fraud." See, e.g., Novak v. Kasaks, 216 F.3d 300 (2d Cir. 2000), cert. denied, 521 U.S. 1012 (2000). At the outset of a case, it may be possible to plead such facts with respect to the management of the corporate defendant (for example, based on insider sales by such persons prior to the public disclosure of the adverse information that caused the stock drop), but it is rarely possible to plead such information with respect to the auditors (who by law cannot own stock in their client). In short, the plaintiff faces a "Catch 22" dilemma in suing the auditor: it cannot plead fraud with particularity until its obtains discovery, and it cannot obtain discovery under the PSLRA until it pleads fraud with particularity.

56 Consulting fees paid by audit clients exploded during the 1990s. According to the Panel on Audit Effectiveness, who was appointed in 1999 by the Public Oversight Board at the request of the SEC to study audit practices, "audit firms' fees from consulting services for their SEC clients increased from 17% ... of audit fees in 1990 to 67% . . . in 1999." See the Panel on Audit Effectiveness, REPORT AND RECOMMENDATIONS (Exposure Draft 2000), at p. 102. In 1990, the Panel
found that 80% of the Big Five firms’ SEC clients received no consulting services from their auditors, and only 1% of those SEC clients paid consulting fees exceeding their auditing fees to the Big Five. Id. at 102. While the Panel found only marginal changes during the 1990s, later studies have found that consulting fees have become a multiple of the audit fee for large public corporations. See text and note infra at note 57. A survey by the Chicago Tribune this year finds that the one hundred largest corporations in the Chicago area (determined on the basis of market capitalization) paid consulting fees to their auditors that were on average over three times the audit fee paid the same auditor. See Janet Kidd Stewart and Andrew Countryman, “Local Audit Conflicts Add Up: Consulting Deals, Hiring Practices In Question,” Chicago Tribune, February 24, 2002, at C-1. The extreme example in this study was Motorola, which had over a 16:1 ratio between consulting fees and audit fees.

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According to one recent survey, the typical large public corporation now pays its auditor for consulting services three times what it pays the same auditor for auditing services. Not only did auditing firms see more profit potential in consulting than in auditing, but they also began during the 1990s to compete based on a strategy of “low balling” under which auditing services were offered at rates that were marginal to arguably below cost. The rationale for such a strategy was that the auditing function was essentially a loss leader by which more lucrative services could be marketed.

Although this argument that the provision of consulting services eroded auditor independence has considerable explanatory power, there is an obvious reply: those who defend the propriety of consulting services by auditors respond that the growth of consulting services made little real difference, because the audit firm was already conflicted by the fact that the client paid its fees. Put as bluntly as possible, the audit partner of a major client (such as Enron) is always conflicted by the fact that such a partner has virtually a “one-client” practice.
Whoever is the gatekeeper - attorney, auditor, or analyst - a “one client” practice compromises the agent. Should the partner lose that client for any reason, the partner will likely need to find employment elsewhere. In short, both critics and defenders of the status quo tend to agree that the individual audit partner is already inevitably compromised by his or her desire to hold the client on whom the agent’s career depends. From this premise, a prophylactic rule prohibiting the firm's involvement in consulting would seemingly achieve little.

Even if true in part, this rebuttal nonetheless misses one key point: namely, the difficulty faced by the client in firing the auditor in the real world.

As discussed below, there are real costs associated with firing an auditor (but, in contrast, none to speak of in firing a consultant). Given this disparity, an unintended consequence of combining consulting services with auditing services in one firm is that the union of the two enables the client to more effectively threaten the auditing firm in a “low visibility” way. To illustrate this point, let us suppose, for example, that a client becomes dissatisfied with an auditor who refuses to endorse an aggressive accounting policy favored by its management. Today, the client cannot easily fire the auditor. Firing the auditor may result in public embarrassment, potential public disclosure of the reasons for the auditor's dismissal or resignation, or a probable SEC intervention. However, if the auditor

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58 Item 4 (“Changes in Registrants Certifying Accountant”) of Form 8-K requires a “reporting” company to file a Form 8-K within five days after the resignation or dismissal of the issuer's independent accountant or that of the independent accountant for a significant subsidiary of the issuer. The Form 8-K must then provide the elaborate disclosures mandated by Item 304 of Regulation S-K relating to any dispute or disagreement between the auditor and the accountant.
also becomes a consultant to the client, the client can then easily terminate the auditor as a consultant (or reduce its use of the firm's consulting services) in retaliation for the auditor's intransigence. This low visibility response neither requires any disclosure, nor invites any SEC oversight, and yet incentivizes the audit firm to replace the intransigent audit partner. In effect, the client can bribe (or coerce) the auditor in its core professional role by raising (or reducing) its use of consulting services.

Of course, this argument that the client can discipline and threaten the auditor/consultant in ways that it could not discipline the simple auditor is based more on logic than actual case histories. But it does fit the available data. A recent study by academic accounting experts, based on proxy statements filed during the first half of 2001, finds that those firms that purchased more non-audit services from their auditor (as a percentage of the total fee paid to the audit firm) were more likely to fit the profile of a firm engaging in earnings management.59

2. The Market Bubble Story

Alternatively, Enron's and Arthur Andersen's downfalls, and the host of other sudden stock declines in 2001 to 2002, can be seen as the consequence of a classic bubble that overtook the equity markets in the late 1990s and produced a

See 17 CFR 228.304 ("Changes in and Disagreements With Accountants on Accounting and Financial Disclosure").

59 See Richard Frankel, Marilyn Johnson, and Karen Nelson, The Relation Between Auditors' Fees for Non-Audit Services and Earnings Quality, MIT Sloan Working Paper No. 4330-02 (available from Social Sciences Research Network at www.ssrn.com at id= 296557). Firms purchasing more non-audit services were found more likely to just meet or beat analysts' forecasts, which is the standard profile of the firm playing "the numbers game."
market euphoria. But what exactly is the connection between a market bubble and gatekeeper failure? Here, a hypothesis needs to be advanced that cannot be rigorously proven, but that is consistent with modern behavioral economics: in a bubble, gatekeepers become less relevant and hence experience a decline in both their leverage over their client and the value of their reputational capital. That is, in an atmosphere of market euphoria, investors rely less on gatekeepers, and managements in turn regard them as more a formality than a necessity.

Gatekeepers provide a critical service only when investors are cautious and skeptical and therefore rely on their services. Conversely, in a market bubble, caution and skepticism are by definition largely abandoned. In such an environment, auditors continue to be used more because SEC rules mandate their use (or because no individual firm wishes to call attention to itself by becoming the first to dispense with them) than because investors actually demand their use. As a result, because gatekeepers have reduced relevance in such an environment, they also have reduced leverage with their clients. Thus, if we assume that the auditor will be largely ignored by euphoric investors, the rational auditor's best
competitive strategy (at least for the short term) was to become as acquiescent and low cost as possible.

Although this thesis assigns some causal responsibility to investors, themselves, for their own losses, it does not absolve gatekeepers from responsibility. For example, even if shareholders do not care much during a bubble about the auditor’s reputation, it is still possible for an auditor to intervene effectively and prevent fraud, either by refusing to certify the issuer’s financial statements, by withdrawing its certificate on a later discovery of the fraud, or by notifying the SEC.61

The key element in this story involves why investors cease to care about the gatekeeper’s reputation. After all, the rise of auditing as a profession was the product of investors’ own concerns about fraud and irregularity, not regulatory requirements. What then caused this concern to weaken? Here, behavioral economics supplies a plausible answer. Modern economics recognizes that individuals, including investors, have “bounded rationality” and do not pursue all information relevant to an optimal decision.62 The Nobel Prize-winning research

61 Section 10A of the Securities Exchange Act of 1934 requires the auditor of a public company to notify the Commission where the auditor discovers an “illegal act [that] has a material effect on the financial statements of the issuer” and management and the board of the issuer have not taken “timely and appropriate remedial action” after notification by the auditor. See 15 U.S.C. §78(j)(A). Since its adoption in 1995, this provision has been seldom, if ever, employed.

62 For overviews of behavioral economics, see Christine Jolis, Cass Sunstein, and Richard Thaler, A Behavioral Approach to Law and Economics, 50 Stan. L. Rev. 1471 (1998); Cass Sunstein, Behavioral Analysis of Law, 64 U.Chi. L. Rev. 1175 (1997). The term “bounded rationality” was coined by Herbert Simon, a Nobel prize winner, and is broadly accepted by most economists. See 1 Herbert A. Simon, Rationality As Process and Product of Thought, 68 Am. Econ. Rev.:
of Professors Kahneman and Tversky has in particular demonstrated that individuals typically make decisions by using heuristics - - that is, rules of thumb - - rather than by incorporating all obtainable information. A heuristic that they find to be pervasively used by individuals and that has particular relevance to the context of securities markets is the “availability heuristic.”63 It asserts that individuals estimate the frequency of an event by recalling recent instances of its occurring (even if these instances are normally rare or infrequent, when viewed from a longer term perspective). Hence, if the stock market has recently experienced extraordinary returns for several years, it becomes predictable that individuals will overestimate the likelihood of such extraordinary gains continuing.64 In effect, there is a status quo or persistence bias - - what has recently occurred is expected to continue. Thus, as the market soared in the early and mid-1990s, investors, operating on heuristics, came to assume that this pattern would continue. Further aggravating this tendency is the deep-seated bias displayed by many individuals toward optimism in predicting future events.65

63 See Jolis, Sunstein and Thaler, supra note 62, at 1477-78. See also, Amos Tversky and Daniel Kahneman, “Judgment Under Uncertainty: Heuristics and Biases” in JUDGMENT UNDER UNCERTAINTY 3 (Daniel Kahneman, Paul Slovic, and Amos Tversky eds. 1982).

64 This is by no means the only way to explain bubbles without resorting to claims of mass delusion. An alternative theory is that institutional money managers have rational incentives to engage in “herding behavior,” preferring a common wrong decision to a risky correct one. See text and notes infra at notes 74 to 76.

Thus, from the perspective of behavioral economics, “bubbles” are not irrational moments of speculative excess or frenzy, but rather are the product of the predictable expectations of individuals who tend to assume that whatever has recently occurred will persist. To trigger this persistence bias, it is arguably only necessary that market returns have in fact been extraordinary for a few successive years in order to cause investors to treat this phenomenon as normal and likely to continue. Such an explanation helps us understand why bubbles have re-occurred throughout history. Their re-occurrence is explained not by the hypothesis that investors are inherently gullible, but by the explanation that a period of extraordinary returns creates an expectation that such returns are normal and will persist.

Such heuristic biases are not, of course, the whole story. For the securities analyst, a market bubble presents a different and more serious challenge: during a bubble, those who are cautious and prudent will be outperformed by those who recklessly predict extraordinary returns. Hence, in a bubble, extreme optimism for analysts becomes less a heuristic bias than a competitive necessity. Put more bluntly, it is dangerous to be sane in an insane world. As a result, the securities analyst who prudently predicted reasonable growth and stock appreciation during the 1990s was increasingly left in the dust by the investment guru who prophesized a new investment paradigm in which revenues and costs were less important than the number of “hits” on a website.

Institutional factors compounded this problem. As the initial public offering (or “IPO”) market soared in the 1990s, securities analysts became
celebrities and valuable assets to their firms; indeed, they became the principal means by which investment banks competed for IPO clients, as the underwriter with the “star” analyst could produce the greatest first day stock price spike in an IPO. But as their salaries thus soared, analyst compensation came increasingly from the investment banking side of their firms. Hence, just as in the case of the auditor, the analyst's economic position became progressively dependent on favoring the interests of persons outside their profession (i.e., consultants in the case of the auditor and investment bankers in the case of the analyst) who had little reason to respect or observe the standards or professional culture within the gatekeeper's profession.

One common denominator linking these examples is that, as auditors increasingly sought consulting income and as analysts became more dependent on an investment banking subsidy, these gatekeepers' normal desire to preserve their reputational capital for the long run become subordinated to their desire to obtain extraordinary returns in the short run by risking that reputational capital. Alternatively, the value of gatekeepers' reputational capital may have simply declined in a bubble, because investors in such an environment rationally reduce

\[66\] For the view that investment banking firms changed their competitive strategies on or around 1996 and thereafter sought the “popular, high-profile analyst" as a means of acquiring IPO clients, see Morgenson, supra note 45 at Section 3-1 (quoting chief investment officer at Trust Company of the West).

\[67\] This idea that professional gatekeepers became dominated by persons outside their profession is at the heart of a recent lawsuit initiated by the New York Attorney General against five chief executive officers of major U.S. corporations. See Patrick McGeehan, “Spitzer Sues Executives of Telecom Companies Over ‘Ill Gotten’ Gains,” New York Times, October 1, 2002, at C-1.
their reliance on gatekeeping services based on their false belief that extraordinary returns will persist. Under either story (or both together), it could have become more profitable for firms to realize the value of their reputational capital by trading on it in the short-run than by preserving it forever. Indeed, during the 1990s, to the extent that auditing became a loss leader for multi-service accounting firms eager to sell more lucrative consulting services and to the extent that securities analysts began to be subsidized by investment banking, each profession became less self-supporting and more dependent on those who wished to profit from the liquidation of their reputational capital.

3. Allocating Responsibility Among Gatekeepers, Managers and Investors

The foregoing explanations still do not fully explain the mechanisms by which reputational capital built up over decades might be sacrificed (or, more accurately, liquidated), once legal risks declined and/or a bubble developed. Here, an allocation of responsibility must be made among the various participants in corporate governance: managers, gatekeepers, and investors.

a. The Role of Managers. The pressure on gatekeepers to acquiesce in earnings management was not constant over time, but rather accelerated during the 1990s as managerial incentives changed. Executive compensation shifted during the 1990s from being primarily cash-based to being primarily equity-based. By 2001, equity-based compensation constituted approximately two thirds of the median annual compensation of chief executives of large public
corporations, up from 8% in the 1990 and 0% in 1984.68 Another measure of this shift is the growth in stock options. Over the last decade, stock options rose from five percent of shares outstanding at major U.S. companies to fifteen percent - - a three hundred percent increase.69 The value of these options rose by an even greater percentage and over a dramatically shorter period: from $50 billion in 1997, in the case of the 2,000 largest corporations to $162 billion in 2000 - - an over three hundred percent rise in three years.70 Stock options create an obvious and potentially perverse incentive to engage in short-run, rather than long-term, stock price maximization because executives can exercise their stock options and sell the underlying shares on the same day.71

The key problem here is not that stock options provide excessive compensation, but that they provide excessive liquidity. This excess liquidity

See Brian J. Hall, “Six Challenges in Designing Equity-Based Pay,” in 15 Accenture Journal of Applied Corporate Finance 21, at 23 and Figure 1 (Spring 2003).


See Morgenson, “Corporate Conduct,” supra note 69, at C-1 (citing study by Sanford C. Bernstein & Co.). Thus, if $162 billion is the value of all options in these 2,000 companies, aggressive accounting policies that temporarily raise stock prices by as little as ten percent create a potential gain for executives of over $16 billion - - a substantial incentive.

See Hall, supra note 68, at 24-29 (surveying misincentives in stock options). This point has also been made by a variety of commentators who have called for minimum holding periods or other curbs on stock options. These include Henry M. Paulson, Jr., chief executive of Goldman, Sachs, and Senator John McCain of Arizona. See David Leonhardt, “Corporate Conduct: Compensation: Anger At Executives’ Profits Fuels Support for Stock Curb,” New York Times, July 9, 2002, at A-1.
was, in turn, partially the product of deregulatory reform in the early 1990s, which relaxed the rules under Section 16(b) of the Securities Exchange Act of 1934 to permit officers and directors to exercise stock options and sell the underlying shares without holding the shares for the previously required six month period.\textsuperscript{72} Thus, if executives inflate the stock price of their company through premature revenue recognition or other classic earnings management techniques, they could quickly bail out in the short-term by exercising their options and selling, leaving shareholders to bear the cost of the stock decline when the inflated stock price could not be maintained over subsequent periods. Given these incentives, it became rational for corporate executives to use lucrative consulting contracts, or other positive and negative incentives, to induce gatekeepers to engage in conduct that assisted their short-term market manipulations. The bottom line is then that the growth of stock options resulted

\textsuperscript{72} Rule 16b-3(d) expressly permits an officer or director otherwise subject to the “short-swing” profit provisions of Section 16(b) of the Securities Exchange Act of 1934 to exercise a qualified stock option and sell the underlying shares immediately “if at least six months elapse from the date of the acquisition of the derivative security to the date of disposition of the ... underlying equity security.” See 17 C.F.R. 240.16b-3(d). The SEC comprehensively revised its rules under Section 16(b) in 1991, in part to facilitate the use of stock options as executive compensation and to “reduce the regulatory burden” under Section 16(b). See Securities Exchange Act Release No. 34-28869, 1991 SEC LEXIS 171 (February 8, 1991). A premise of this reform was that “holding derivative securities is functionally equivalent to holding the underlying equity security for purpose of Section 16.” Id. at *35 to *36. Hence, the SEC permitted the tacking of the option holding period with the stock’s holding period, thereby enabling officers and directors to exercise options and sell on the same day (if the option had already been held six months).
in gatekeepers being placed under greater pressure to acquiesce in short-term oriented financial and accounting strategies.

b. The Role of Investors. Investors cannot be fairly presented as entirely innocent victims in the recent epidemic of financial irregularities. At a minimum, a bubble reflects investors’ acquiescence in unrealistic valuations. More importantly, conflicts of interest on the part of gatekeepers that might alarm investors in other circumstances may be accepted (or at least repressed) during a bubble. To be sure, many investors were likely misled by biased analyst research and overstated earnings, but this does not absolve the “buy side” of all responsibility. Particularly in the case of institutional investors, who account for over half the ownership and seventy-five percent of the trading in NYSE-listed equities, financial intermediaries may again have failed. According to one estimate, at the peak of the market, sixty percent of Enron stock was held by large institutional investors. Why didn’t they see that Enron was overvalued, at least once alarm bells began to sound? A plausible explanation for the failure of institutional investors to respond to warning signals in the case of Enron starts from the premise that professional money managers are principally motivated by the desire to perform no worse than their major institutional rivals; this pressure quickly leads to herding behavior. According to this analysis, fund managers

\[ \text{For these statistics, see James D. Cox and Randall Thomas, } \textit{Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?}, 80 \text{ Wash. U. L. Q. 855 n. 4 (2002).} \]

\[ \text{See Healy and Palepu, supra note 35, at 22.} \]

\[ \text{The term “herding” was coined over a decade ago by Scharfstein and Stein. See David S. Scharfstein and Jeremy Stein, } \textit{Herd Behavior and Investment}, 80 \text{ Amer.} \]
attract investor funds and maximize their fees based on their “quarterly reported performance relative to comparable funds or indices.”76 Thus, if a fund manager discovers that Enron is overvalued and sells his firm’s investment, the manager and the managers clients do well - - but only if the market agrees and Enron’s stock price falls that quarter. If the market persists in overvaluing Enron or actually climbs based on biased “sell-side” research, the manager becomes an unfortunately premature prophet, and the manager’s performance relative to his rivals falls. Precisely to the extent that this manager is accountable to the market, clients’ funds flow out of their manager’s account to those of rival fund managers, thereby collapsing like an accordion the funds under his management, so that this manager does not profit significantly even when Enron ultimately does collapse. In such an environment, there is little incentive to be ahead of the crowd and considerable incentive to ride the bubble to its top in order not to underperform rival investment managers. The result is “herding” because, by following the herd, the fund manager will not underperform most of the manager’s rivals. Put differently, the fund manager can survive mistakes that others also make, but will be more severely injured by correct decisions that the market only belatedly recognizes. In turn, this may explain why institutions would herd and follow “sell-side” research that they know to be biased: that is, because they anticipated that others would follow it also, leaving them in the safe position of being part of the herd.

76 Eco. Rev. 465 (1990); see also Healy and Palepu, supra note 35, at 26-27. Id. at 26.
c. The Role of Gatekeepers. This conclusion that even sophisticated investors will follow and rely on “sell-side” research that they know to be biased brings us back to the central role of gatekeepers. To some degree, gatekeepers will be followed even when they are not trusted, because it is expected that they will influence the market. In addition, there is evidence that gatekeepers “herd” for careerist reasons. For example, career concerns appear to motivate security analysts not to deviate far from the consensus earnings forecasts, and particularly to avoid downward deviations. As a result, it becomes predictable that some degree of bias will distort analyst recommendations (and that such advice will be followed), even when the market expects inflation. Moreover, ending the most obvious conflicts of interest (as Sarbanes-Oxley and related reforms attempt to do) will not solve this problem, because the careerist motives will remain.

4. A Preliminary Evaluation. Does it matter which of the foregoing two stories - the deterrence story or the bubble story - is deemed more persuasive? Although they are complementary rather than contradictory, their relative plausibility may bear on whether particular reforms are necessary, desirable, or sufficient. To the extent one accepts the deterrence story, the logical prescription is legal change aimed at restoring an adequate legal threat. In principle, these changes could either raise the costs or lower the benefits of acquiescence to

auditors (or both). To the extent one accepts the bubble story, the problem may be self-correcting. That is, once the bubble bursts, gatekeepers come back into fashion, as investors become skeptics who once again demand assurances that only credible reputational intermediaries can provide. Alternatively, structural reforms may be desirable to enhance the independence of analysts, auditors, and other gatekeepers. Clearly, all gatekeepers are not alike. Thus, the deterrence story may work better for auditors than for analysts, while in the case of analysts, structural reforms aimed at increasing the independence of the gatekeeper may outperform litigation remedies.

Part II: The Near Future of Gatekeepers: Sarbanes-Oxley and the Looming Litigation Crisis

Historically, bubbles are followed by crashes, which in turn are followed by punitive legislation. The 1999-2003 era is fully consistent with this pattern, and this section will focus on the likely impact of these reforms on gatekeepers.

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78 Federal Reserve Chairman Alan Greenspan has indeed suggested that market corrections will largely solve the problems uncovered in the wake of Enron. See “Remarks by Chairman Alan Greenspan, ‘Corporate Governance’ at the Stern School of Business, New York University, New York, New York, March 26, 2002” (available on the Federal Reserve website at www.federalreserve.gov/boarddocs/speeches). In his view, earnings management came to dominate management’s agenda, and as a result: “It is not surprising that since 1998 earnings restatements have proliferated. This situation is a far cry from earlier decades when, if my recollection serves me correctly, firms competed on the basis of which one had the most conservative set of books. Short-term stock price values then seemed less of a focus than maintaining unquestioned credit worthiness.” Id. at 4. He goes on to predict that: “A change in behavior, however, may already be in train.” Id. at 5. Specifically, he finds that “perceptions of the reliability of firms' financial statements are increasingly reflected in yield spreads of corporate bonds” and that other signs of self-correction are discernible. Id.

79 For a discussion of this cycle over history, see Banner, supra note 6.
Initially, however, it is useful to categorize the range of strategies that Congress can follow in response to corporate scandals and conflicts of interest.

A. A Typology of Conflict of Interest Reforms

There are a range of well recognized strategies for responding to corporate financial scandals, each of which has well-known precedents. While other typologies can undoubtedly be constructed, the following four categories capture most of the realistic regulatory options:

1. Structural Reform. A new body or agency can be created, either public or private, to monitor conflicts and assure higher quality disclosure. The Securities and Exchange Commission, created by the Securities Exchange Act of 1934 in the wake of the 1929 market crash, is probably the clearest example of such a response, but the creation of the Public Company Accounting Oversight Board (“PCAOB”) by the Sarbanes-Oxley Act to monitor auditing firms is a modern example that follows in its wake.

Structural reforms can also change the obligations of private actors. For example, the law can create a new gatekeeper. In the 1930s, the federal securities laws and the SEC effectively made auditors into gatekeepers for the public (and not just for the clients who retained their services), and to a limited extent the

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80 Title I of the Sarbanes-Oxley Act creates the PCAOB as a regulatory body subject to SEC oversight, and Section 101(c) of the Act further directs the PCAOB to “establish or adopt...auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports for” publicly held issuers. See 15 U.S.C. § 7211(c).
SEC has already begun to impose gatekeeping responsibilities on attorneys and securities analysts. Part III will suggest that these initial steps should be generalized.

2. **Prophylactic rules.** Fiduciary law has long simply forbidden some forms of self-dealing between the fiduciary and the beneficiary. Thus, the trustee cannot transact business with the trust estate, because such transactions are either void or voidable. Over the course of the 20th Century, American corporate law largely relaxed the prohibition on self-dealing, provided that certain procedures were followed.\(^\text{81}\) Offsetting this trend in state law, however, the federal securities laws introduced new prophylactic prohibitions, including a prohibition on a corporate officer or director retaining the proceeds of certain forms of short-term trading in his or her company’s stock.\(^\text{82}\) Sarbanes-Oxley has now introduced similar rules, most notably including a prohibition on a public company making or arranging for loans to its executives.\(^\text{83}\)

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\(^\text{81}\) For a detailed discussion of the gradual relaxation over the last 150 years of American corporate law of the once standard prophylactic rule against self-dealing, see Harold Marsh, Jr., *Are Directors Trustees?*, 22 Bus. Law 35 (1966). Essentially, disclosure to, and approval by, disinterested directors replaced proof of the transaction’s intrinsic fairness as the necessary precondition to sustaining a self-dealing transaction’s validity.

\(^\text{82}\) Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b), mandates that senior officers, directors and 10% shareholders must return to the corporation any profits they make, or losses they avert, on purchasing and selling the corporation’s stock in any sequence within six months. The provision is a federal rule intended to discourage manipulation of the corporation’s stock price by insiders.

\(^\text{83}\) Section 402 of the Sarbanes Oxley Act, which has been codified as Section 13(k) of Securities Exchange Act of 1934, forbids public companies “directly or indirectly,...to extend or maintain credit, to arrange for an extension of credit, or to renew an extension of credit, in the form of personal loan to or for any director
3. **Procedural rules.** The core of American corporate law is full of procedural rules requiring disclosure of conflicts of interest by corporate officers to disinterested directors. Indeed, American corporate law has largely substituted procedural rules for its former prophylactic prohibitions on conflict of interest transactions. Yet, events at WorldCom, Enron, Tyco and other companies suggest that such rules may not be adequately effective, either because outside directors have too little incentive to monitor diligently or because information costs are too high. Nonetheless, as discussed below, Sarbanes-Oxley also followed this time honored path and enacted new procedural rules.

4. **Liability rules.** The standard response to a corporate scandal is to enhance liability rules, either by increasing penalties, eliminating defenses, or creating new private causes of action. The Securities Act of 1933 is here the classic example, as it creates virtual strict liability for the corporate issuer if issuer’s registration statement contains a material misstatement or omission. Yet, as discussed below, Sarbanes-Oxley basically did not follow this path, except to the extent that it increased criminal penalties and SEC powers.

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or executive officer...of that issuer.” See 15 U.S.C. § 78m(k). This is in effect a throwback to the form of strict prophylactic rule that characterized 19th and early 20th Century American corporate law.

For an overview of these rules that require disclosure and approval by disinterested directors of a self-dealing transaction, see J. Choper, J. Coffee and R. Gilson, CASES AND MATERIALS ON CORPORATIONS (5th ed. 2000) at 112 to 130. For a representative cases, see Fleigler v. Lawrence, 361 A.2d 218 (Del. 1976); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

Section 11 of the Securities Act of 1933 creates strict liability for the issuer (but grants a variety of affirmative defenses to secondary participants) if the registration statement contains a material misstatement or omission of which the purchaser was unaware. See 15 U.S.C. § 77(k).
B. Congress’s Response: The Sarbanes-Oxley Act

Passed almost without dissent, the “Public Company Accounting Reform and Investor Protection Act of 2002” (popularly known as the Sarbanes-Oxley Act) essentially addresses the problem of accounting irregularities by shifting control of the accounting profession from the profession to a new body: the PCAOB, which is authorized to regulate the profession, establish auditing standards, and impose professional discipline. Conceptually, this is not a new approach, as the PCAOB’s authority largely parallels that of the National Association of Securities Dealers (“NASD”) over securities brokers and dealers. What is new, however, is explicit recognition of the significance of conflicts of interest, because the Act expressly bars auditors from providing a number of categories of professional services to their audit clients and further authorizes the PCAOB to prohibit additional categories of consulting services. Thus, to the extent that conflicts of interest compromised auditors, the Act responds with a relevant answer.

Yet, if accounting irregularities were more the product of a lack of general deterrence or the increased incentive of corporate executives to “cook the books” because of the temptations created by stock options, the Act is less clearly

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86 Section 101(c) of the Act enumerates broad powers, including the authority to “establish ... auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers....”

87 Section 201 of the Act, which is to be codified as Section 10A(g) of the Securities Exchange Act of 1934, specifies eight types of professional services which the auditor of a public company may not perform for its audit client, and also authorizes the PCAOB to prohibit additional services if it determines that they may compromise auditor independence.
responsive to these problems. For example, except in one minor respect, the Act does not seek to revise or reverse the PSLRA, nor does it make gatekeepers liable in private litigation to investors where the gatekeeper knowingly aided and abetted a securities fraud. Finally, the Act never addresses stock options or executive compensation, except to the extent that it may require the forfeiture of such compensation to the corporation if the corporation later restates its earnings. In short, while the potential benefits from acquiescing in accounting irregularities appear to have been reduced for auditors, the expected costs to them from gatekeeper failure also remain low because the level of deterrence that they once faced has not been restored. Arguably then, the Sarbanes-Oxley Act represents an incomplete response. But this assumes that courts have not largely filled this void.

C. The Judicial Response

Any assertion that gatekeepers face an inadequate deterrent threat assumes that all other factors affecting their total exposure to liability have remained

88 Section 804 of the Act does extend the statute of limitation for securities fraud suits, thereby reversing a 1991 Supreme Court decision that had shortened the time period. See supra note 48.

89 Section 304 of the Act requires the forfeiture of certain bonuses “or other incentive-based or equity-based compensation” and any stock trading profits received by a chief executive officer or chief financial officer of an issuer during the 12-month period following the filing of an inflated earnings report that is later restated. This does cancel the incentive to inflate earnings and then bail out, but the enforcement methods applicable to this provision are unspecified and the provision applies only if the earnings restatement is the product of “misconduct.” Ambiguities abound here.

90 Prior to the 1990s, private litigation was a real (and arguably even excessive) constraining force on auditors. See text and note supra at note 47.
constant, and this may not be the case. Although the Congress has been cautious about changing the balance of advantage in civil litigation involving gatekeepers, the judiciary may be rapidly shifting that same balance without waiting for legislative direction. The most obvious example of such a shift is the decision in late 2002 in In re Enron Corp. Secs., Derivative & ERISA Litig., \(^{91}\) which seemingly has outflanked the Supreme Court’s decision in Central Bank of Denver, \(^{92}\) and largely restored private “aiding and abetting” liability under a different name. In the Enron case, the district court denied the motions to dismiss filed by Enron’s auditors, its principal outside law firm, and six major banks, all of whom asserted that they could not be deemed primary violators and so were immune from private suit under Central Bank. In response to their motions, the Court ruled that primary liability could extend to any person who contributes materially false or misleading information to persons who it understands to be preparing or drafting a report or press release to be filed with the SEC or disseminated to the investing public, even though this peripheral defendant neither solicited sales, participated in the actual drafting of the document, nor was otherwise identified in the document so filed or released.\(^{93}\) The Enron decision not only rejected the majority rule in the federal courts, which seems to permit a private suit against the secondary participant only when the latter makes or authorizes an “attributed statement” that specifically identifies it and its

\(^{91}\) 235 F. Supp. 2d 549 (S.D. Tex. 2002).
\(^{93}\) 235 F. Supp. 2d 549, 582-591.
conclusion, but also went well beyond the few cases that have allowed primary liability to extend to persons who “substantially participate” in the drafting of an SEC document. Under the Enron ruling, almost anyone who could formerly be reached under “aiding and abetting” liability now seemingly can be reached as a “maker” or “creator” of public statement.

Whether the Enron decision is correct can be (and is being hotly) debated. But the more relevant point for this article is that the decision seemingly signals a judicial shift - - whether conscious or unconscious - - toward imposing greater liability on gatekeepers. Moreover, Enron is not the only recent post-scandal decision to have expanded the scope of liability for secondary participants. In a series of decisions involving Lernout & Hauspie, another federal court has refused to dismiss securities fraud allegations in private class actions against a variety of secondary defendants, including the firm’s outside directors, auditors, stock analysts, and others. Unlike the Enron Court, the Lernout & Hauspie Court did not need to focus on whether the defendant corporation’s audit committee

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94 See Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998) (requiring that “the misrepresentation must be attributed to the specific actor at the time of public dissemination”).

95 In re Software Toolworks Secs. Litig., 50 F.3d 615, 627 (9th Cir. 1994) (using “substantial participation” test).


members had substantially participated in the drafting of SEC reports or press releases. Rather, because each director had signed the defendant’s Form 10-K, the Court found this fact alone sufficient to deem the audit committee members to have made a fraudulent statement. In an even more sweeping conclusion, the Court further found that audit committee members could be held liable as “controlling persons” under Section 20(a) of the Securities Exchange Act of 1934. Under long-established SEC rules, “control” “means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person.” Although the Lernout & Hauspie Court acknowledged that outside directors were not inherently “control persons,” it relied on an earlier decision to find that: “[A]n outside director and audit committee member who is in a position to approve a corporation’s financial statements can be presumed to have the `power to direct or cause the direction of the management and policies of’ the corporation, at least insofar as the `management and policies’ referred to relate to ensuring a measure of accuracy in the content of company reports and SEC registrations that they actually sign.” Although this conclusion did not rely on the Sarbanes-Oxley Act, which cannot apply retroactively to the facts of Lernout & Hauspie, that statute only reinforces this mode of analysis because it greatly enhances the powers of the audit committee, thus making them look more

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like “controlling persons.” As a result, audit committee members would now seem significantly more exposed to personal liability. Finally, although a plaintiff is still required to plead facts raising a strong inference of fraud, the Lernout & Hauspie Court found this last requirement satisfied by the fact that the audit committee members all allegedly had known that their corporation lacked an adequate system of internal controls and that its outside auditor had raised specific problems with its financial reporting.\footnote{Id. at ** 8 to ** 10.} Again, on this basis, many audit committee members could be held liable in the near future.

The net impact of these rulings is to substantially heighten the prospective liability of audit committee members. By signing a periodic report, by helping to draft such a report, or by acquiring knowledge of adverse facts as a “controlling person,” audit committee members face a non-trivial risk of personal liability. From a public policy perspective, this may be counterproductive because one wants an active, hard-working audit committee to seek diligently to acquire such information. Thus, if the acquisition of adverse information were to make the audit committee potentially liable as “controlling persons,” a disincentive arises, ironically created by legal rules, for the gatekeeper to do precisely what the law most desires.

On the state level, some signs of a similar, if milder, shift toward imposing heightened responsibilities on directors are also evident in Delaware, where respected members of its judiciary have called for new legislation and an
expanded meaning to be given to the critical Delaware concept of “good faith.” ¹⁰²

These comments have warned that a conflicted director may not be found to have
acted in “good faith.” “Good faith” is a key requirement under Delaware law,
because, in its absence, a Delaware corporation cannot indemnify an officer or
director; in addition, charter provisions eliminating monetary liability for breach
of the duty of care (which most public companies in the U.S. now have) are
ineffective if the director did not act in “good faith.” ¹⁰³ In short, all the judicial
straws in the wind point towards a higher risk of liability, although for the present
the principal target of this new litigation appears to be directors, rather than
gatekeepers.

D. The Prospective Litigation Impact of Reform.

Little agreement exists about the overall impact of the Sarbanes-Oxley Act
on civil litigation. Some critics have viewed it as more rhetoric than serious
reform;¹⁰⁴ others contend that it is a sweeping intrusion into the U.S.’s existing
system of corporate governance. Both perspectives miss, however, what it most
important: Sarbanes-Oxley ushers in and accelerates a major and probably
inevitable transition, which will move us from a rules-based system of financial

¹⁰² See William B. Chandler III and Leo E. Strine, Jr., The New Federalism of the
American Corporate Governance System: Preliminary Reflections of Two
Mr. Chandler is the Chancellor and Mr. Strine a Vice Chancellor of the Delaware
Chancery Court. See also Tom Becker, “Delaware Judge Warns Boards of
¹⁰³ See Delaware General Corporation Law Section 102(b)(7) (permitting charter
provision to eliminate due care liability if director acted in “good faith”).
¹⁰⁴ See Lawrence A. Cunningham, The Sarbanes-Oxley Yawn: Heavy Rhetoric,
The quoted language is from Section 906, which has been codified as 18 U.S.C. § 1350, a penal code provision (emphasis added). Section 302 of Sarbanes-Oxley Act uses slightly different language: “the financial statements, and other financial information included in the report, fairly presents in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report.” No difference in scope or meaning seems
concept of “fair presentation” is not limited by any reference to GAAP, and compliance with GAAP is clearly not dispositive of whether the issuer has provided a “fair presentation.” Instead, the standard seems to intend that the issuer provide full and fair disclosure in the form of a holistic picture of the company that reveals all material financial weaknesses, even if their disclosure were not required by GAAP.

Actually, this concept of “fair presentation” was once the standard prescribed by Judge Henry Friendly for the Second Circuit in United States v. Simon,106 but over recent years Simon had seemingly become a forgotten decision, honored more in the breach than in the observance.107 Virtually overnight, however, Enron and related scandals have resuscitated Simon’s concept of “fair presentation.” The reason for its revival is obvious: Enron showed beyond argument that a rules-based system of financial disclosure could be gamed and distorted to the point that investors could have little confidence in it. Even if newer and tighter rules were drafted, practitioners would predictably stay one step ahead of regulators by finding new ways to game and evade narrow and specific rules. As a result, Congress and the SEC framed the Sarbanes-Oxley

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106 425 F.2d 796, 807-09 (2d Cir. 1969).
107 No Circuit Court decision that I have found over the past twenty years appears to cite the Simon case in a decision upholding civil or criminal liability for securities fraud. The decision has been cited by dissenting judges who believed that a case should not have been dismissed or overturned. See, e.g., In re K-Tel Int’l Sec. Litig., 300 F.3d 881, 906 (8th Cir. 2002). The last decision citing it favorably in a decision favoring private plaintiffs or the SEC appears to have been SEC v. Seaboard Corp., 677 F.2d 1301, 1313 (9th Cir. 1982).
Act’s new certification requirements in terms of the Simon case, and in interpreting this new requirement, the SEC has cited Simon for the proposition that: “Presenting financial information in conformity with generally accepted accounting principles may not necessarily satisfy obligations under the antifraud provision of the federal securities laws.”108

While this shift to a principles-based system is obviously consistent with the public’s post-Enron mood, it poses significant risks for issuers and gatekeepers. Cases that might have been dismissed on summary judgment now seem more likely to survive, because the claim that full and fair disclosure was not provided is hard to resolve pre-trial. Here, the differences between the European and the American legal environment become starkly apparent. Lacking class actions, contingent fees, or the “American rule” that generally precludes fee-shifting against the plaintiff, Europe experiences little securities litigation and hence can tolerate abstract generality in the formulation of its accounting rules. In contrast, U.S. issuers are likely to encounter greater difficulty in any transition to accounting principles framed in broad brush strokes. The combination of broad disclosure obligations and a legal environment that encourages class litigation means both a higher volume of litigation and higher settlement values to claims against gatekeepers and outside directors.

Nonetheless, this transition appears inevitable, not only because of recent scandals, but because of globalization as well. Globalization necessitates a

common, world-wide accounting language. Under their “Norwalk treaty,” the Financial Accounting Standards Board (“FASB”) and the International Accounting Standards Board (“IASB”) are committed to developing international accounting standards that both U.S. and European regulators will accept.109 Europe has little interest in moving towards a rule-based regime, and the FASB cannot credibly push in this direction after Enron. As a result, the development of a common global accounting language will likely finish what Enron started: namely, the demise of a rules-based system.

So where do these trends leave us? The original issue was what level of legal threat would optimize deterrence. Too high a level of liability may cause the contemporary markets for gatekeeping services to fail, and too low a level invites future Enrons. This recognition has two implications that inform Part III. First, public policy should attempt to focus liability rules so that they punish laxity, but do not employ an overwhelming level of deterrence. Second, to the extent that it is impossible to define on a practical level the optimal level of legal threat and to the extent that courts appear to be increasing that threat on their own today, other types of legal rules - - structural, prophylactic and procedural - - may merit greater attention and should be blended into any overall policy response.

Part III. The Future Gatekeeper: Remedies for Gatekeeper Failure.

109 The two bodies - - the FASB and the IASB - - announced in October, 2002, that they were committed to achieving convergence between their respective accounting standards by 2005 with an initial exposure draft being scheduled for late 2003. See “Convergence of Global Accounting Standards; Regulatory Watch,” Accounting Today, January 25, 2003, at p. 512 (describing memorandum of understanding between the two bodies).
Three linked problems dominate any attempt to redefine the role or restructure the obligations and liabilities of market gatekeepers:

First, public policy must strike an appropriate balance between excessive liability and an inadequate legal threat. Precise calibrations are probably impossible because volatile, exogenous factors -- such as the public’s mood, including both its skepticism of corporate actors and its desire for retribution -- can quickly change the actual legal threat faced by gatekeepers. This is a uniquely American problem because the prospect of large class actions and jury decision-making is almost unique to the American legal system. On the practical political level, the most relevant and plausible reform would be to increase the legal threat that gatekeepers face by restoring “aiding and abetting” liability. Yet, if this were done at the same time as public (or judicial) attitudes became more skeptical of the business community generally (and gatekeepers specifically), the result arguably might be to generate overdeterrence. The dilemma here is that if the gatekeeper faces excessive risks that it cannot pass on to the client in its fees, the market for gatekeeping services may simply fail. That is, established firms would cease to offer auditing services, and only smaller, less risk averse firms would undertake this role, gambling that they could reap a high return before litigation destroyed them.

Second, public policy must eliminate or minimize the impact of perverse incentives that give the gatekeeper an incentive not to investigate. For example, in securities litigation against auditors, the defense is frequently raised by the auditors that they were deceived by corrupt managements on whom they had
justifiably relied. Often, this may be true, but it can still create an incentive not to inquire too closely - - lest one acquire information that should place one on notice. More generally, the Private Securities Litigation Reform Act requires a particularized pleading at the outset of the case that gives rise to a “strong inference of fraud.”\textsuperscript{110} In the case of accountants, this standard means that more than reckless indifference must be shown and as of the very outset of the action, when typically little is known about the accountant’s involvement. As a result, the auditor who remains ignorant of the fraud, even though reckless inattentive, probably escapes liability.

But how much can we realistically expect of the auditor? Auditors have long argued that there is an “expectations gap” between what the public wants to do and their actual capacity.\textsuperscript{111} This expectations gap is greatest, they assert, when it comes to the ability of auditors to detect fraud or illegal acts.\textsuperscript{112} Of course, any profession has a collective self-interest in reducing its own risk of liability or public criticism. Still, the result may be that the accounting industry

\textsuperscript{110} See Section 21D(b)(2) of the Securities Exchange Act of 1934, 15 U.S.C. §78u-3 (requiring complaint to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind”).


\textsuperscript{112} Over 70% of investors questioned in one survey expected absolute assurance that material misstatements due to fraud would be detected. See Marc Epstein & Marshall Geiger, Investor Views of Audit Assurance: Recent Evidence of the Expectations Gap, J. Acct. (Jan., 1994) at 60.
spends great time, effort, and expense in seeking to reduce the public’s expectation that it should be able to detect fraud, rather than single-mindedly enhancing its capacity to do so. Courts in turn devote considerable time and resources seeking to distinguish those cases in which the auditor knew of the fraud from those in which it was merely negligent. This effort may, however, be socially wasteful if an alternative legal regime could be designed under which auditors were held liable for any undetected fraud without exposing them to penalties that caused the market to fail. Such an alternative system would be superior both because (i) it would not require courts to make often difficult and costly determinations as to whether the auditor was complicit in the fraud or merely negligent and (ii) it would maximize the auditor’s incentive to detect fraud (as opposed to explaining it away as undetectable). Of course, any shift in this direction of strict or negligence based liability also increases the prospect that the market for auditing services might collapse under the weight of excessive liability - - unless a ceiling is placed on damages.

Third, public policy must also strike an acceptable balance between the obligation of client loyalty and the role of protecting the integrity of the market. This is the unique problem associated with asserting that securities attorneys owe gatekeeper obligations - - either legal or ethical - - to investors, as well as to their clients. Defenders of the traditional advocacy role of the lawyer find this conflict unbridgeable, and argue that imposing gatekeeper obligations on attorneys will simply “dry up” the free flow of information between attorney and client, thus possibly resulting in greater illegality. This section finds this claim to be
unsupportable. Rather, it concludes that the primary consequence of imposing gatekeeper obligations on attorneys will be to increase their leverage over their clients.

a. **Striking the Balance on Liability.** On the theoretical level, some commentators have proposed that gatekeepers should be held strictly liable for client misconduct. Under such a system, for example, an auditor would pay damages whenever its client, the issuer, made a material misrepresentation or omission in its financial statements, without regard to whether the auditor knew, or was negligent in failing to detect, the misrepresentation or omission. The rationale for such a strict liability system is that it will induce auditors to implement the optimal combination of auditing, bonding, and other measures to detect financial irregularities (whether or not fraudulent) without imposing the considerable burden on courts that our current fault-based system does.

Obviously, under such a system, gatekeepers will raise their fees, but this increase is presented as one of the attractions of this approach because it forces the client that cannot convince its auditor that it presents a low risk of fraud or material error to bear a higher fee. In a perfect market, the issuer would thus bear the expected social cost of the fraud, which would in turn imply that the only issuers that could access the market would be “those for whom the value of the public

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114 See Partnoy, supra note 113, at 514.
financing exceeds the harm caused by fraud.”

Put more simply, very high audit fees should tend to deter the fraudulent actor.

Although possibly optimal in theory, enormous problems surround implementation of any such proposal. First, as even its proponents acknowledge, the gatekeeper may not be able to distinguish ex ante the “honest” client from the “fraudulent” one. Hence, it will charge both a single common fee - - but a much higher one. Predictably, this inflated fee structure will allow the “fraudulent” client still to access the market, but may well drive many honest clients from the market. Even if we relax this assumption and assume that some broad risk classifications could be made, it still remains true that, to the extent these classifications are broad and general, then some clients within each category will pay too little and others too much.

Moreover, the increase in audit fees would have to be enormous in order to enable auditors to survive under a regime of strict liability. During the collapse of the high tech bubble in 2000 and 2001, publicly held firms audited by the Big

See Hamdani, supra note 113, at 6. This analysis rests on a broader economic analysis that sees strict liability as superior to negligence-based liability in two respects: first, strict liability gives the principal actors optimal incentives to comply with legal requirements, while freeing courts from the need to make imperfect and error-prone liability determinations, and, second, it induces the principal actors to adopt an optimal level of activity. See Steven Shavell, ECONOMIC ANALYSIS OF ACCIDENT LAW 6-7 (1987).

This is, of course, the core consequence of a “lemons market” in which the quality of the product cannot be easily determined. See George Akerlot, The Market for Lemons: Quality Uncertainty and the Market Mechanism, 84 Q. J. Econ. 488 (1970).
Five fell by over $1 trillion in market value.\textsuperscript{117} Under a strict liability regime, the auditor would be jointly and severally liable for this amount with the issuer, at least if a material misrepresentation or omission were shown. To protect itself against such exposure, the auditor would need to charge a fee that funded its expected liability costs - - which loss could potentially reach into the tens of billions of dollars.\textsuperscript{118} Most clients could simply not pay such an amount, and all would oppose such a fee increase with sufficient vigor as to make the adoption of strict liability politically infeasible.

Given the risk of being rendered insolvent by a single client, some auditors also might simply cease to offer auditing services. Conceivably, their position in the market might be filled by smaller, risk-preferring “fly-by-night” firms that would hope to charge very high fees for the short-term and then liquidate on an adverse determination (and protect their partners’ assets through use of limited liability organizational forms, such as the limited liability company or partnership).

\textsuperscript{117} Indeed, one survey of 33 public firms that restated their earnings finds that the Big Five audited companies that fell in value by roughly $1.3 trillion. See Stephen Taub, “Big Five Gets Low Grades For Performance,” Economist.com, July 12, 2002 (noting fall from $1.8 trillion to only $527 billion in market capitalization).

\textsuperscript{118} Of course, securities class actions today settle for a fraction of their asserted losses. But this fraction will certainly rise (and steeply) if we moved to a strict liability regime. Even today, neutral third parties have placed the likely settlement value of some outstanding securities class actions at $1 billion or higher. See Martin Peers, “Suits Cloud AOL’s Optimism; Cost of Settling Holder Litigation May Hurt Effort to Cut Debt,” Wall St. J., May 1, 2003, at B2 (estimating settlement cost of securities class action against AOL Time Warner Inc. at $1 billion).
Finally, there still remains the possibility of litigation error. Even under a regime of strict liability, it would still be necessary to show that the issuer made a material misrepresentation or omission before the auditor could be held vicariously liable. Given the potential of stock price drops resulting in damages of $100 billion or more, this means that litigation errors would be bankrupting to the auditor, which in turn means that the auditor would be under great pressure to settle such litigation. Such pressure in turn exacerbates the problem of “extortionate” or “frivolous” litigation. Stock prices can fall for a variety of reasons that are unrelated to fraud or misrepresentation. Yet, if the stock price decline is great enough, an almost irresistible incentive arises for the plaintiff’s attorney to sue, as it has now been freed from the burden of alleging, pleading, or proving fraud or scienter. Hence, the prospect of “frivolous” or “extortionate” litigation increases in direct proportion to the degree to which one moves toward a strict liability regime.

b. Designing a “Stricter” Liability Approach: A Proposal. For all these reasons, the “real world” issue becomes whether a second-best substitute can be devised for a strict liability regime that sidesteps or minimizes the foregoing problems. The most practical means to this end may be to convert the gatekeeper into the functional equivalent of an insurer, but one who backs its own certification with an insurance policy that was capped at a realistic level. As a

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119 In addition, it would be necessary for the plaintiff to prove loss causation, as otherwise in its absence the plaintiff would receive a seeming windfall. Thus, some complex litigation issues will still remain.
result, the gatekeeper’s liability would be divorced from any showing of fault, but would also be limited to a level that achieves adequate deterrence without causing the market for gatekeeping services to unravel. Under this approach, for example, if the corporate client were found liable for $100 million, then the auditor would have to contribute toward that liability up to the amount of its policy. The one mandatory element in this proposal would be that the minimum floor on the gatekeeper’s insurance policy would have to be an adequate multiple of the highest annual revenues received by the gatekeeper from its client over the last several years. For purposes of illustration, let’s use a multiplier of ten. Now, on the facts of the Enron case, where it has been widely reported that Arthur Andersen received roughly $52 million from Enron in its final year, Andersen’s liability would be not less than $520 million (i.e., $52 million times ten). This is a large number, but it does not approach the roughly $87 billion loss in market capitalization that Enron experienced and for which Andersen could conceivably be held liable under a strict liability regime. In a more typical cases where the auditor receives only a $2 million audit fee from the client, the damages would be reduced to only $20 million. Hence, the market for gatekeeping services could easily function under this proposal. The auditor might also purchase insurance to cover its exposure, but to the extent it passed along this added insurance cost on to its clients, it would automatically increase the minimum required floor on its policy under the mandatory 10:1 ratio between minimum liability and direct or indirect revenues from the client.
Some will recognize this proposal as bearing considerable resemblance to Professor Partnoy’s modified strict liability proposal. Under his innovative proposal, the client and the gatekeeper would contract for the gatekeeper to bear a minimum percentage of the issuer’s losses, possibly subject to a requirement that the gatekeeper must bear some “specified minimum percentage.” Suppose the minimum percentage set by Congress in an amendment to the federal securities laws were 5%. If so, on the earlier Enron example, Andersen would be required to pay 5% of Enron’s $87 billion loss or $4.35 billion.

There are essentially three practical differences between these two similar proposals: (1) Professor Partnoy’s system is essentially contractual, while this proposal is essentially regulatory; (2) Professor Partnoy uses a percentage of the damages as its potential minimum floor, while this proposal uses a multiple of the gatekeeper’s highest annual revenues from the client; and (3) while the potential damages, as calculated under Professor Partnoy’s proposal, could often bankrupt the gatekeeper, bankruptcy would rarely follow when a multiple of the revenues from the client generated the required minimum floor on the gatekeeper’s insurance obligation. Thus, this proposal could actually be supported by the

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120 See Partnoy, supra note 113, at 540-46; see also Stephen Choi, Market Lessons for Gatekeepers, 92 Nw. U. L. Rev. 916, 951-59 (1998). Professor Choi appears to have been the first to suggest that the issuer and the gatekeeper should contract over the share of the gatekeeper’s liability for the losses experienced by the issuer’s investors.

121 Partnoy, supra note 113, at 540. Actually, Professor Partnoy does not clearly insist that there be a minimum floor placed on the auditor’s liability below which they could not deviate by agreement, but notes that Congress could impose such a minimum percentage. Id.
relevant profession, once they recognized that their existing exposure to liability could be even higher. It thus falls (if only barely) within the range of political feasibility.

This proposal’s refusal to accept private contracting (in contrast to Professor Partnoy, who relies primarily on contracting and disclosure) is based on three considerations: First, some gatekeeping professions (most notably, auditing) are extremely concentrated, and thus conscious parallelism in the pricing behavior of the few actors in the industry becomes likely. Put more simply, if there are only four major auditing firms at present, it becomes unlikely that they would compete vigorously and accept liability significantly above any minimum required threshold. Hence, it is simpler to specify that threshold (but also permit the parties to provide by contract for even greater liability). Second, in a bubble, investors might not care that their gatekeepers were accepting only a minimum liability, and thus the disclosure of the contract between the gatekeeper and the market might have little impact on the market. Third, a contractual approach overlooks that the corporate client may have little incentive to bargain for high liability on the part of the auditor. Not only will higher auditor liability not meaningfully reduce the liability of the client (given the typical relative disparity in their assets), but corporate managers may actually want the auditor to have a low ceiling on its liability in order to make it easier to induce the auditor to acquiesce in risky accounting practices favored by management. Put more simply, if management wants to inflate earnings in order to maximize the value of
their stock options, the lower the liability faced by their auditors, the easier it will be for management to convince them to acquiesce in dubious accounting policies.

The key conceptual difference between the two proposals involves this proposal’s more explicit adoption of a deterrence framework. Prior proposals for making the auditor an insurer have relied on a tort law rationale, which tries to force the tortfeasor to internalize the social costs of its actions by making it pay a higher fee. As earlier discussed, this is impractical, given the potentially astronomical liabilities involved. From a deterrence perspective, however, the goal of reform shifts from internalization of the externalities to prevention. Under standard deterrence theory, prevention requires that the expected punishment cost exceed the expected gain.\textsuperscript{122} Professor Partnoy’s proposal to use a percentage of the issuer’s losses as the minimum floor on contracting does not bear any functional relationship to the expected gain; nor does it increase the penalty to compensate for the limited risk of detection.

To illustrate the difference between the two proposals consider a very large issuer that experiences a sudden $50 billion decline in its market capitalization as the result of accounting irregularities. Assume further that the issuer’s auditor had received only $10 million in fees, and that Professor Partnoy would limit the auditor’s exposure to 10% of the total loss (or $5 billion). Thus, there is here a 500:1 ratio between the auditor’s projected liability ($5 billion or 5% of the losses) and its own gain ($10 million). This represents overdeterrence-

- unless one thinks there is only a 5% chance of detection. In even a minimally efficient market, however, the prospect of detection of accounting irregularities seems far higher than that. In contrast, this article would impose a ceiling on auditor liability at $100 million (or 10 times its gain). Obviously, this article’s proposal of stricter liability with a lower ceiling based on a multiple of the revenues from the client creates less liability, but still gives the gatekeeper ample incentive to utilize all monitoring controls (including closer monitoring of its own agents) that are reasonably likely to reduce the prospect of fraud or earnings manipulation. Also, this approach reduces the prospect of “frivolous” or extortionate litigation directed against the auditor based only on the total amount of the investor losses. Above all, this approach prevents the market for gatekeeping services from unraveling.

How strict should a stricter system of liability be? Here, we enter the thicket of political realism. Pure strict liability might be the best rule, but it is probably not politically acceptable to auditors. Nor does it seem defensible to impose a significantly higher standard of liability on the auditor than on its client, the issuer. In this light, the highest standard of liability that might be politically attainable in the case of auditors would be that set forth already for auditors in Section 11 of the Securities Act of 1933, which requires the auditor as an expert to prove as an affirmative defense that the auditor “had, after reasonable investigation, reasonable grounds to believe and did believe that “its statement
were true. In effect, the burden would be shifted to the auditor in all Rule 10b-5 actions to prove its non-negligence and good faith belief in its statements.

c. Implementing the Gatekeeper Role of Attorneys. The foregoing proposal for “stricter liability” has been primarily framed with auditors in mind. But should it apply to other gatekeepers, such as, for example, attorneys or stock analysts? Here, some basic distinctions among gatekeepers need to be recognized. While the auditor inhabits a relatively precise and rule-bound world, the analyst is essentially a prognosticator whose predictions about the future are frequently wrong. Thus, imposing strict liability on the analysts, given their necessarily higher rate of error, represents a virtual death sentence for the analyst. In addition, the analyst cannot pass on its higher exposure to liability to its client in the form of higher fees, because the analysts is not paid by the corporate issuer (but rather by investors through brokerage commissions). If brokerage commissions were increased, investors simply turn to discount brokers (or others), who did not use stock analysts.

The case of the attorney presents even greater differences: First, functionally, attorneys act only occasionally as gatekeepers, certifying or verifying information for investors, while auditors perform this function primarily (and increasingly exclusively). Second, the role of gatekeeper arguably conflicts with the more typical roles performed by attorneys as either advocates or transaction engineers for their clients. Third, asking attorneys to serve as

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gatekeepers may dry up the flow of confidential information between attorney and client, thereby jeopardizing the ability of the attorney to serve the client. Based on these premises, the bar (and its academic defenders) have vehemently argued that, if the attorney were compelled to serve as a watchdog, instead of as an advocate or transaction engineer, for the client, the client could no longer depend on the attorney as a zealous advocate or transaction engineer.\(^{124}\)

But even if there is an inconsistency between these roles, what does this imply? At least in theory, one could separate the roles of the attorney as gatekeeper from that of the attorney as transaction engineer by employing multiple counsel. That is, the corporation could use different law firms, one to plan and structure and the other to supervise disclosure. Obviously, this would be costly, because duplicative work would be performed. Yet, this is what Sarbanes-Oxley essentially did to the accountant, divorcing the roles of auditor and consultant because of the clear conflict of interest. Arguably, the same conflict is present in the case of the attorney. In any event, such a separation need not be legally mandated in the case of the attorney, because it could be left to the corporation to decide if it felt sufficiently threatened by an attorney who was under a legal obligation to make full disclosure that it wished to hire multiple counsel.

\(^{124}\) For a detailed exposition of this argument that the roles of the attorney and the gatekeeper are essentially inconsistent and that attorneys make poor informational and reputational intermediaries, see Jill E. Fisch and Kenneth M. Rosen, Is there Role for Lawyers in Preventing Future Enrons? (forthcoming in Villanova Law Review in 2003) (available on SSRN Electronic Library at id= 367661).
Although the SEC has long taken the position that any attorney who knowingly files a false or misleading statement or document with the SEC aids and abets the client’s fraud,\textsuperscript{125} it has never articulated a general statement of the attorney’s gatekeeper role. In particular, the SEC’s recent rules under Section 307 of the Sarbanes-Oxley Act, which authorizes the SEC to promulgate minimum standards of professional conduct for securities attorneys, focus only on the reporting of material violations of law and make no broader attempt to provide any conceptual overview of the attorney’s responsibility to investors.\textsuperscript{126} Although the SEC has commendably focused on the controversial issue of whether a securities attorney should ever be required to make a “noisy withdrawal” that would warn investors of pending illegality, it has ducked the broader and seemingly prior issue of the attorney’s overall obligations to these investors. For example, minimum standards of professional conduct could (1) require the attorney to perform reasonable due diligence with respect to the statements made in disclosure documents that the attorney drafts for the corporate client; (2) mandate standards of independence for attorneys performing certain sensitive tasks; and (3) subject the attorney to professional discipline for negligence or malpractice, thus giving the SEC a useful enforcement tool in cases where it suggest misconduct but cannot easily prove scienter.

\textsuperscript{125} See, e.g., SEC v. Fehn, 97 F.3d 1276 (9th Cir. 1995).
On the still undefended premise that securities attorneys should serve as gatekeepers for investors, this article will make three specific proposals. First, the SEC should adopt a limited certification requirement mandating that a securities attorney acknowledge that it has reviewed the non-financial disclosure in publicly filed reports; second, it should establish independence standards for attorneys performing certain tasks that require them to be independent of management, such as the conduct of internal corporate investigations for publicly held firms; and third, the SEC should deem negligence by attorneys in the preparation of SEC disclosure documents to amount to unprofessional conduct for which attorneys could be disciplined under the SEC’s Rules of Practice (just as auditors can be disciplined today). Uniting these proposals is the idea that the attorney should perform a due diligence investigation of the corporation’s non-financial disclosures that roughly corresponds to the auditor’s role with respect to financial disclosures.

1. A Negative Assurance Certification. A certification requirement applicable to attorneys can be justified simply on the grounds of consistency. Today, a publicly-held corporation’s CEO and CFO must certify that each periodic report “fairly presents in all material respects” the issuer’s “financial condition and results of operations.” Similarly, the securities analyst must also

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127 See Rule 102(e)(1)(iv) of the SEC Rules of Practice, 17 CFR § 2001.102(e)(1)(iv) (authorizing SEC to suspend or censure an accountant for “a single instance of highly unreasonable conduct...[or]...repeated instances of unreasonable conduct.”

128 See text and notes supra at notes 105 to 109 (discussing certification requirements under Sections 302 and 906 of Sarbanes-Oxley).
today certify that the analyst truly agrees with his or her research advice to investors.\textsuperscript{129} Thus, managers, auditors and analysts all certify their work, but the corporations’s principal counsel does not. Arguably, the attorney should not be able to escape a corresponding obligation, particularly because the auditor takes no responsibility for the textual portion of the disclosure document, which is independent of the financial statements that the auditor certifies. In effect, attorney certification mandates a parallel expert to review the non-financial disclosures of the public corporation, but the attorney as gatekeeper would not be asked to perform an audit or check facts in the manner that an auditor does.

Specifically, the attorney principally responsible for preparing a document or report filed with the SEC should certify (1) that such attorney believes the statements made in the document or report to be true and correct in all material respects, and (2) that such attorney is not aware of any additional material information whose disclosure is necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.\textsuperscript{130}

The real thrust of this proposal is to require the issuer to subject its principal disclosure documents to the scrutiny of an attorney who would be under a professional obligation to exercise some level of “due diligence” in their

\textsuperscript{129} See Securities Act Release 33-8193 (February 20, 2003) (adopting Regulation AC, which requires a research analyst employed by a broker or dealer to certify that the views expressed in the research report accurately reflect his or her personal views).

\textsuperscript{130} Issues could arise as to which attorney was principally responsible for preparing a document. The simplest answer to this issue is to require the corporation to disclose the identity of such attorney in the filing and then require that attorney’s certification.
An open question, on which this article takes no position, is whether such review should be by an attorney “independent” of management - - a term that additional SEC rules could define.

For a description of this standard opinion in registered public offerings, see Richard Howe, Rethinking Legal Opinion Letters: The Duties and Liabilities of Attorneys in Rendering Legal Opinions, 1989 Colum. Bus. L. Rev. 283, 287 (1989). The author of this article, a partner at the New York firm of Sullivan and Cromwell, properly observes that “such opinions are not really ‘legal opinions’ at all in that they do not state any legal conclusion but only say that the attorney believed certain facts to be true.” Id. Precisely for this reason, such an opinion is more a pledge of the law firm’s reputational capital, which the underwriters demand. The counsel giving such opinion does not purport to conclude that all information required to be disclosed has been disclosed (as an auditor might by analogy), but only that it lacks personal knowledge or belief as to any such failure. See also Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 Yale L. J. 239, 291 (1984) (also describing such opinions); Richard W. Painter, Toward A Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules, 63 Geo. Wash. L. Rev. 221, 226-27 and n.19 (1991) (discussing judicial interpretation of such opinions). The American Bar Association has characterized this type of opinion as a “negative assurance” and finds such opinions to be “unique to securities offerings.” See ABA Comm. on Legal Opinions, Third-Party Opinion Report, Including the Legal Opinion Accord of the Section of Business Law, American Bar Association, 47 Bus. Law. 167, 228 (1991). Although the ABA considers it generally inappropriate for attorneys to request such “negative assurance” opinions from other attorneys, the special context of securities offerings is exempted, reflecting the fact that underwriters consider such an assurance to be necessary to them. That the ABA, as the representative of the bar, “disfavors”
periodic filings what is already done in the primary market for 1933 Act
disclosure documents; the real difference is that the case of periodic filings under
the Securities Exchange Act, there is no analogue to the underwriter to demand
such an opinion or certification from the attorney. Thus, SEC action would fill
this void. In addition, such a requirement would have a profound symbolic and
psychological effect on the bar because it would recognize the attorney’s
obligations as a gatekeeper. Ideally, the SEC should go even further and require
the attorney to certify that the attorney so believed “after making such inquiry that
the attorney reasonably believed appropriate in the circumstances;” this would
establish at least a minimal due diligence obligation.

Admittedly, limits need to be recognized on what an attorney can certify.
Because the attorney does not audit its client, the attorney should not be asked to
certify the accuracy and completeness of all information disclosed in SEC filings.
Thus, the proposal here made requires only a negative certification that the
attorney had no reason to believe, and did not believe, that the information was
materially false or misleading. Legally, such a certification would trigger “aiding
and abetting” liability if the attorney was aware of materially false or misleading
information, and it could even trigger criminal liability under various federal
statutes. But its primary effect is to recognize that the securities attorney is a
gatekeeper for investors.

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such opinions because of the demands they place on the attorney probably only
underscores the value of such a reform.
2. **Independence.** Auditors, of course, must be independent of their client, and SEC rules have long defined tests for auditor independence. Increasingly, a new literature has warned that attorneys are becoming too economically interconnected with their client to exercise independent judgment, as the result in part of the increasing practice of law firms taking (and even demanding) equity stakes in the client in return for professional services. If some level of independence is necessary for an attorney to function as a gatekeeper, SEC rules of professional conduct could define these limits. To illustrate, a law firm that holds in its portfolio 10% of the corporate client’s equity (or, alternatively, equity in the client equal to 10% of its own net asset value) will probably be a poor, or at least a biased, monitor.

In any event, the context that is most sensitive and would most benefit from such rules is that of internal corporate investigations. Often, such investigations are mandated by the SEC, and typically the resulting reports are filed with the SEC. Should the corporation’s normal outside counsel perform such an investigation? Or, should SEC rules define the level of independence necessary to conduct such a more sensitive inquiry? Absent SEC action, individual state bar associations will either do nothing (the most likely outcome) or prescribe different and inconsistent standards, thereby creating needless disparities. Uniform standards for corporate internal investigations are desirable

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and as a practical matter can only come from the SEC. There is no need to offer precise rules here, but only to recognize that professionals are expected to be independent of their clients. Accordingly, the SEC should read Section 307 to grant it authority to define the point at which the attorney is not sufficiently independent of the client to perform certain sensitive tasks.

3. **The Due Diligence Obligation.** Certification is only a first step. The next logical step would be to mandate due diligence by the attorney in preparing or reviewing SEC filings as a minimum standard of professional conduct. Here, Sarbanes-Oxley changes the picture significantly, because Section 307 of Sarbanes-Oxley authorizes the SEC to establish “minimum standards of professional conduct for attorneys appearing and practicing before the Commission….” This reference to “professional conduct” would certainly seem to empower the SEC to adopt rules requiring the attorney both to conduct a minimal due diligence review before the attorney files a document or report with the SEC and to certify its good faith belief in the accuracy of the statements made therein. Indeed, in its existing Rules of Practice, the SEC already holds auditors to precisely such a standard and asserts the power to suspend or disbar them for merely negligent conduct.\(^\text{134}\) If this can be done without special statutory authority, then it seems to follow a fortiori, after the enactment of Section 307,

\(^{134}\) See 17 C.F.R. § 201.102(e)(iv) (specifying that two forms of “negligent conduct” - - either “a single instance of highly unreasonable conduct” or “repeated instances of unreasonable conduct” - - could trigger sanctions under Rule 102(e)).
that the SEC could require attorneys to take reasonable steps to investigate the accuracy of statements made in documents that they prepare.¹³⁵

The bottom line then is that the SEC is today empowered to adopt rules that could suspend or disbar an attorney for negligence as a form of professional misconduct. Negligence would clearly not support a private cause of action under Rule 10b-5, but it may be the appropriate standard for the imposition of sanctions under Section 307.¹³⁶ Such a tradeoff - i.e., public liability but not private liability for negligence - again seems desirable in that it enhances deterrence without threatening insolvency for law firms.

d. Accessing Counter-Arguments: Can Attorneys Be Gatekeepers? Any assertion that the SEC should compel the securities attorney to play a greater gatekeeping role inevitably runs into the argument that such a role is either inappropriate for attorneys or will reduce their clients’ willingness to confide in them. The first claim that such a role is inappropriate depends largely on one’s vantage point. Litigators tend to view the attorney as an advocate for, and protector of, the client - a bulwark between the client and an oppressive state.¹³⁷

¹³⁵ The attorney would, of course, be entitled to rely on the auditor with respect to financial information certified by the auditor, as in the case of the “reliance on an expert” defense under Section 11(b)(3)(c) of the Securities Act of 1933. See 15 U.S.C. Section 77(k)(b)(3)(c).

¹³⁶ Historically, the SEC did once hold attorneys liable for professional negligence in “aiding and abetting” cases. See SEC v. Spectrum Ltd., 489 F.2d 535, 536 (2d Cir. 1973). This is no longer possible after the Supreme Court mandated a scienter standard in Hochfelder, but sanctions for professional misconduct could look to a similar standard.

Securities attorneys are less ready to buy into this rhetoric, however, and do not have the same self-image of themselves. For the most part, they agree that they have at least an ethical responsibility to perform due diligence on documents they draft and file with the SEC. For over a quarter century, prominent securities attorneys have recognized that, as a result, their professional role is closer to that of the auditor than to that of the litigator. The key elements that distinguish the
attorney as advocate from the attorney as gatekeeper are: (1) a need for greater independence from the client; (2) a recognition of a duty to the public; and (3) professional skepticism. Exactly these differences need to be recognized by the SEC under Section 307.

The more important counter-argument to imposing gatekeeper obligations on securities attorneys is that attorneys will be unable to communicate as freely with their clients if gatekeeper obligations or “noisy withdrawal” requirements were imposed. In response to this claim, it is first necessary to recognize that the ultimate goal of the law is to achieve law compliance, not to maximize uninhibited communications between the attorney and the client. The norm of client confidentiality is a means to an end, not the end in itself.

Still, even with this concession, it remains true that lawyers can counsel most effectively when there is open, relatively unconstrained communication between their clients and themselves. Hence, the practical issue becomes whether gatekeeper obligations would necessarily chill desirable attorney/client communications. The stress here should be on the word “desirable.” What would

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139 See A.A. Sommer, supra note 138, at 317-319. Thus, the “crime/fraud” exception to the attorney/client privilege makes some communications between attorney and client discoverable, even though this result thereby arguably makes clients less ready to confide in their attorneys. The justification for this result, which applies similarly to this context, is that communications so excluded from the privilege are deemed socially undesirable. For the current status of this exception, see In re Richard Roe, Inc., 168 F.3d 69 (2d Cir. 1999). See also David N. Zarnow & Keith Krakaur, On the Brink of a Brave New World: The Death of the Privilege in Corporate Criminal Investigation, 37 Am. Crim. L. Rev. 147 (2000) (suggesting that the attorney/client privilege is already highly qualified in this context).
be the likely impact of the SEC’s proposed “noisy withdrawal” standards on such communications? Here, a starting point for this analysis should be the recognition that the client knows little law and will almost always want to know if contemplated action is illegal. From this premise, it follows that the corporate official contemplating prospective action will still inquire of counsel whether the course of action under consideration is lawful. Indeed, the more the government pursues white collar criminal prosecutions and punitive regulatory actions in the contemporary post-Enron environment, the more in turn that corporate officers are likely to inquire before they act. When then will communications be most likely to be chilled? The obvious answer is that the officer who has already acted may fear inquiring of an attorney if the officer’s conduct was lawful -- precisely because the officer fears that the attorney may be under an obligation to report unlawful actions to higher authorities or, indirectly, to the SEC. In short, it is the “ex post” inquiry by the client of the attorney that is most likely to be chilled.

If one accepts this premise that ex ante communications between counsel and the client are less likely to be chilled than ex post communications, several implications follow: First, the impact of imposing gatekeeper obligations on attorneys may be socially desirable. In a well-known article, Professors Kaplow and Shavell have argued that the case for protecting ex ante communications between attorneys and clients is far stronger than the case for protecting ex post communications.\textsuperscript{141} Advice before action leads individuals to comply with the

\textsuperscript{141} See Louis Kaplow and Steven Shavell, \textit{Legal Advice About Information to Present in Litigation: Its Effects and Social Desirability}, 102 Harv. L. Rev. 565 85
law, they argue, whereas \textit{ex post} advice does not provide a guide for action and may simply allow the defendant to reduce the expected penalty costs, thus encouraging illegality. It is not necessary to fully accept the Kaplow/Shavell analysis to see that its core distinction between \textit{ex ante} and \textit{ex post} advice suggests that we should be more concerned about chilling “\textit{ex ante}” communications between attorney and client. But this is not what most gatekeeper obligations do; rather, they may induce such communications by making “\textit{ex post}” advice less possible.

Second, requiring “noisy withdrawals” and “up-the-ladder” reporting also has a deterrent value that is independent of this issue of whether the initial corporate actor will still consult counsel. Few significant actions within a corporation can be taken by a single actor. Decisions made by one person still need to be implemented by others. Thus, even after the initial corporate actor has taken an irrevocable step (and will thereafter be arguably less willing to consult with counsel \textit{ex post}), other corporate actors will need to be contracted and convinced to cooperate with the initial actor. They will have every incentive to consult with counsel because they are still at the “\textit{ex ante}” stage. In turn, knowledge that others are necessarily likely to learn of the original actor’s conduct and to consult with counsel about its legality may deter the original actor. The modern public corporation is embedded with in-house attorneys, and even the possibility that they will report “up the ladder” should deter some illegal conduct.

\cite{posner99}
Hence, even if under some conditions there may be less direct communication between corporate actors and counsel, knowledge that sooner or later counsel is likely to learn ex post can still deter corporate actors ex ante.

As a result, the principal practical effect that imposing gatekeeper obligations will have on clients is that a client who has been advised by an attorney that contemplated action is unlawful now has greater reason to heed that attorney’s advice - - again precisely to the extent that the client believes that the attorney may be under a legal obligation to report any misconduct (either inside the corporation or outside). Thus, even if it were true that clients would consult less, this impact could be more than fully offset by the fact that it would become more dangerous to disregard the lawyer’s advice. Add to this mix the likelihood that “ex ante” advice will not be chilled, and the net impact is to increase the attorney’s leverage over the client by making it more dangerous to ignore the attorney’s advice. If law compliance is the goal, such an impact seems socially desirable.

CONCLUSION

The diagnosis of “gatekeeper failure” made in Part I of this article leads naturally to a multi-part prescription for law compliance: the law should create, empower and deter gatekeepers. Deterrence is easy, but it can be overdone. Thus, although this article has favored a shift towards stricter liability, it has coupled this recommendation with a proposed ceiling on liability set at the level necessary to deter the gatekeeper. In essence, this proposal subordinates compensation to deterrence - - but only with regard to litigation against
gatekeepers, who are seldom in any event in a position to fund full compensation to the investor class.

Empowerment is a trickier question. If we are to reduce accounting and financial reporting irregularities, the optimal strategy must both motivate and empower gatekeepers to insist upon law compliance. In the case of the attorney, the first step toward making the securities attorney a gatekeeper should be to enhance their leverage over their clients in order to enable them to exert greater pressure for law compliance. A mandatory attorney certification standard, enforced by a due diligence obligation, does essentially this by forcing the client to seek the attorney’s review. In addition, a “noisy withdrawal” standard reduces the possibility that the client will disregard the attorney’s advice or “shop” for a favorable opinion from the most compliant attorney.

Gatekeeper empowerment necessarily requires intruding upon our existing guild-like structure of private self-regulation of the professions. Sarbanes-Oxley already does this in the case of the accounting and analyst professions, but the SEC has not yet compelled the legal profession to recognize that - - like it or not - - attorneys are also gatekeepers. To be sure, law firms cannot be insurers in the manner that accounting firms could, but their choice is not “all or nothing.” Professions, like guilds, will predictably resist any increase in their responsibilities and liabilities to the public, but, if reforms are pressed, they will lose. Still, in the absence of gatekeeper reform, the certainty remains that recurrent gatekeeper failure will continue.